

March 2, 2016

Dueling Liens in Lean Times

By [Kim Mai](#), [Buddy Clark](#) and [Kraig Grahmann](#)

With the steep collapse of oil and gas prices in the last eighteen months, dozens of exploration and production companies have declared bankruptcy and many more companies are expected to file for bankruptcy protection unless prices rebound dramatically. As the prospect of further bankruptcies looms, it is important for parties to understand how to adequately protect their security interests and the nature of competing liens that could prevent them from fully realizing on the value of the collateral securing their counterparty's obligations. This article sets forth types of liens that can encumber the assets of an exploration and production company and the priority of such liens.

Secured Lender's Liens

A secured lender's loan documentation generally consists of a mortgage that creates a lien on a company's real property oil and gas interests, a security agreement that creates a lien on a company's personal property and financing statements that perfect the security interests on hydrocarbons produced from the oil and gas properties ("as-extracted" collateral) and other personal property. To properly perfect a security interest on "as-extracted" collateral, the financing statement should be filed in the recorder's office of the county or parish in which the "as-extracted" collateral is located. To perfect a security interest on all other personal property, the financing statement should be filed with the office of the secretary of state in the state in which the debtor is located, which for business organizations is the entity's state of incorporation or organization.

In the majority of states, a mortgage is also effective as an "as-extracted" collateral filing, but as with standard financing statements, the effectiveness of a mortgage as an "as-extracted" collateral filing will lapse in five years unless a continuation statement is filed during the six-month period prior to the end of the five-year period. Only the Texas Business and Commercial Code has provided an exception to this general rule by stating that a mortgage is effective as a financing statement on "as-extracted" collateral until the mortgage is released, satisfied of record or its effectiveness otherwise terminates as to the real property. Therefore, for older credit facilities, lenders should confirm that their "as-extracted" collateral filings have not lapsed. Furthermore, for all credit facilities secured by real property outside of Texas, lenders may consider filing separate "as-extracted" collateral filings, despite the fact that the mortgage may qualify as an "as-extracted" collateral filing, in order to assist them in tracking the expiration dates of the "as-extracted" collateral filings. As discussed in this article, even if a lender has a perfected security interest in the collateral that is purportedly a "first-priority lien," the collateral may still be subject to a variety of liens, some of which will have priority over the lender's perfected lien.

Mechanic's and Materialmen's Liens

Mechanic's and Materialman's liens are an available remedy in all states to protect providers of services and materials for the drilling of oil and gas wells. Texas, for example, has a separate statutory lien for oil field mechanics and materialmen in Chapter 56 of the Texas Property Code that allows mineral contractors and material providers to obtain liens against mineral property to recover unpaid balances for materials and services related to mineral activities, while other states will either only have a general mechanic's lien or incorporate oil and gas specific statutes into a general mechanic's lien act.

In select states, the protections of a mechanic's and materialman's lien will extend to an operator even though the operator is not the provider of the labor or materials at issue. In Oklahoma, for example, a court held that the services that an operator performed in the operation of an oil and gas well should be within the "labor and services" provision of Oklahoma's lien statute. In Texas, the lien will not extend to production from the leasehold.

To perfect a mechanic's and materialman's lien in Texas, a sworn lien affidavit must be filed in the office of the county clerk of the county in which the property is located not later than six months after the date materials or services were last provided. Furthermore, in Texas, the properly perfected mechanic's and materialman's lien relates back to the date when services or materials were first provided and will have priority over a lender's security interests in the same collateral if the lender's lien is filed after the mechanic's and materialman's lien holder first provided services or materials.

Joint Operating Agreement Liens

There are four versions of the model American Association of Professional Landmen Form Joint Operating Agreement, but parties most frequently use the 1982 and 1989 forms. Under the 1989 Joint Operating Agreement, each of the operator and non-operator grants to each other consensual liens on both current and future acquired real property and the personal property associated with such real property. In contrast, the 1982 form only grants the operator a lien on the non-operator's properties and must be amended to create a lien in favor of a non-operator. Liens granted pursuant to a Joint Operating Agreement secure obligations by the parties thereunder, including, but not limited to the non-operator's payment of expenses, interests and fees and the operator's obligation to properly disburse money paid under the Joint Operating Agreement.

Historically, parties have not always recorded their liens and security interests under the Joint Operating Agreement, but immediate recordation of the liens is essential. If a party fails to record its liens, then it could be reduced to an unsecured creditor when its Joint Operating Agreement counterparty files for bankruptcy. Parties often record their liens by filing a Memorandum of Joint Operating Agreement in the real property records of the county in which the property subject to a potential lien claim is located. The parties should ensure that the Memorandum of Joint Operating Agreement is properly acknowledged and satisfies both the notice requirements in the state in which the real property is located to perfect the liens on the real property and the requirements of an enforceable financing statement to perfect the security interest in personal property. Reference to the Joint Operating Agreement in another document in the chain of title, such as a deed of trust, can also provide subsequent lien claimants with constructive notice of lien rights granted under the Joint Operating Agreement. In most states, including Texas, a lienholder that has properly perfected security interests granted under the Joint Operating Agreement will have priority over any subsequent lienholders, including lenders who filed liens pursuant to mortgages.

A future alert in our series on distress in the oil and gas markets will discuss Joint Operating Agreement lien remedies in further detail.

First Purchaser Liens

Several producing states have enacted statutes to grant royalty owners and producers a statutory lien securing the first purchaser's payment for production. Texas' statutory protection is under Section 9.343 of the Texas Business and Commercial Code and provides a security interest in favor of "interest owners" in order to secure the obligation of the "first purchaser" of oil and gas production to pay the purchase price of such production. A person who has an interest of "any kind or nature in oil and gas production at the time of severance" is an "interest owner." A "first purchaser" is the first person who purchases the oil or gas from an operator or interest owner after the oil or gas has been produced. An operator will generally be considered a first purchaser if it collects proceeds of production on behalf of other interest owners pursuant to a division order or other agreement, but will not be considered a first purchaser if it has not yet received proceeds from the third-party purchaser. The interest owner's security interest exists in "the

oil and gas production as well as the identifiable proceeds of that production that are owned by, received by, or due to the first purchaser.”

The security interest in Texas is created by an authenticated record that gives the interest owner a right under real property law. The act of the first purchaser in signing an agreement to purchase production, in issuing a division order or in making any other voluntary communication to the interest owner or a governmental agency recognizing the interest owner’s right, operates as an authenticated record under Section 9.343 of the Texas Business Commerce Code. The security interest is automatically perfected, without filing a financing statement, and will have priority over any purchaser who is not a buyer in the ordinary course of the first purchaser’s business. Under Section 9.343 of the Texas Business Commerce Code, the security interest will also have priority over other Chapter 9 security interests, such as a lender’s mortgage.

If a purchaser is incorporated in a state that does not have a statute allowing for automatic perfection, producers must, in light of the *In re SemCrude, L.P.* (“**SemCrude**”) decision, file a financing statement in the state that the purchaser is located, which for business organizations is the state of incorporation or organization. In *SemCrude*, the Delaware bankruptcy court held that the security interest of producers in the purchasers’ oil and gas production, who had failed to file financing statements, was subordinate to the security interest of secured lenders who had properly filed a financing statement. The Delaware district court later affirmed the bankruptcy court’s decision. *SemCrude* involved producers with properties in numerous jurisdictions; however, the bankruptcy court applied the Uniform Commercial Code’s choice-of-law rules provisions to determine that Delaware and Oklahoma (neither of which had statutes that specifically subordinated Article 9 security interests to the interests of interest owners) governed perfection rather than Texas. Specifically, the court found that the laws in which a debtor is located, rather than the laws where the oil and gas were produced, govern perfection. Following the *SemCrude* decision, the Oklahoma legislature revised its Oil and Gas Owners’ Lien Act to provide that interest owners are granted an automatically-perfected lien that, with limited exceptions, has first priority over other competing perfected liens even if such competing liens are first in time.

Even if producers believe that the law of a state that has adopted statutory protections for interest owners governs, they should still consider filing a financing statement in the purchaser’s state of incorporation or organization in case a court decides that conflict of laws principles dictate another state law governs and to increase the likelihood of higher priority against competing perfected liens. Furthermore, in Texas, if an interest owner files a deed, mineral deed or assignment, or any other such record in the real property records, such record will be effective as a financing statement, and the interest owner will have priority over another interest owner that has a security interest that was automatically perfected without a filing.

In addition to filing financing statements, interest owners can require purchasers to obtain the consent of lenders to grant such interest owners a first priority security interest in oil and gas production and proceeds to secure unpaid invoices with respect to such production.

Environmental Liens

Under Superfund and Texas’ comparable statute, the Texas Solid Waste Disposal Act (“**SWDA**”), remediation costs incurred by the government give rise to a lien on the property remediated. Under Superfund and SWDA, environmental liens do not have priority over prior recorded liens, but in other states, such as Arkansas, Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, and Tennessee, a lien securing remediation costs is a “Superlien” that takes priority over prior recorded liens, including mortgages. Moreover, in select states a lien may be imposed on both the property that is subject to remediation and on other real and personal property owned by the owner of the remediated property; however, such liens do not constitute “Superliens” and must be recorded. Because there is no way for a lender to gain priority over “Superliens,” lenders should conduct thorough due diligence to ensure that properties securing their loans are not contaminated, as well as include environmental covenants and indemnities in their credit agreements and security instruments.

Recoupment and Setoff

The right of recoupment provides an operator with the right to recoup outstanding amounts owed by non-operators, including amounts outstanding under Joint Interest Billings, from the revenues owing to the non-operators. The automatic stay in bankruptcy applies to the right of recoupment, but an “administrative freeze” is available pending relief from the stay. Recoupment rights apply to amounts owing both pre- and post-petition. To exercise the recoupment remedy, an operator has to prove that the amounts owed under a contract offset debts under the same contract. In Texas, case law indicates that recoupment rights of an operator are superior to a bank mortgage.

Setoff refers to a second remedy that operators can use to collect amounts owing to it from a non-operator. Similar to recoupment rights, a party seeking to set off amounts it is owed can seek an “administrative freeze” on an automatic stay. Unlike the right of recoupment, outstanding amounts owing to the offsetting party and the debts such party owes do not have to be under the same contract. The Bankruptcy Code provides that a claim subject to setoff is a secured claim to the extent an amount is eligible to setoff, but the right of setoff only applies to pre-petition amounts. Courts are divided on whether the Uniform Commercial Code governs the priority of setoff rights, so an analysis of whether the “first-in-time, first-in-right” rule applies will have to be conducted on a state-by-state level. If the rule applies, then a bank’s lien will have priority over setoff rights.

Conclusion

Once a debtor files for bankruptcy, the automatic stay bars a wide variety of creditor actions against the debtor or its properties, and will, in most instances, prevent a holder of an unperfected lien from perfecting its lien. There are certain exceptions to the automatic stay, such as a mechanic’s lien that arose prior to a debtor’s bankruptcy filing if under state law the creditor could have perfected its lien in the absence of bankruptcy. Furthermore, Section 544 of the Bankruptcy Code permits the trustee to avoid unperfected liens or security interests.

Therefore, secured parties should ensure that their liens are filed in a timely manner and the recording instruments and financing statements satisfy requirements under the real property laws and the Uniform Commercial Code of the applicable jurisdictions. A secured party that fails to properly perfect its security interest will become an unsecured creditor and, in most cases, will have little recourse or possibility of recovering on the collateral. Because any modifications to documentations or filings, generally, must occur more than 90 days before a debtor files a bankruptcy petition, lienholders should act quickly to protect their interests. Creditors should also be aware of other potentially competing liens and interests, such as tax liens and federal and state plugging and abandonment obligations, which are beyond the scope of this article.

For more information, please contact:

[Buddy Clark](#)
713.547.2077
buddy.clark@haynesboone.com

[Scott Helbing](#)
214.651.5532
scott.helbing@haynesboone.com

[Ian Peck](#)
214.651.5155
ian.peck@haynesboone.com

[Jeff Civins](#)
512.867.8477
jeff.civins@haynesboone.com

[Michael Cooper](#)
214.651.5465
michael.cooper@haynesboone.com

[Kraig Grahmann](#)
713.547.2048
kraig.grahmann@haynesboone.com

[Kim Mai](#)
713.547.2029
kim.mai@haynesboone.com

Read about our [energy related bankruptcy reports and surveys](#).