

Security Interests: Oil & Gas

JEFF NICHOLS, ELLEN CONLEY AND DENNY LEE, HAYNES AND BOONE, LLP,
WITH PRACTICAL LAW FINANCE

Search the [Resource ID numbers in blue](#) on Practical Law for more.

A Practice Note discussing oil and gas and the means by which a lender can perfect a security interest in them. This Note also explains key terms in oil and gas collateral and contains information about types of interests and first purchaser statutes.

Oil and gas financing is a specialized area of law that can be a trap for the unwary. This Note identifies issues in oil and gas financing generally and specifically for properly perfecting a security interest in oil and gas assets.

OIL AND GAS FINANCE

Oil and gas finance is the financing of the exploration and production (E&P) companies that explore and drill for oil and gas. Companies involved in the oil and gas industry are divided into three categories. Most E&P companies are upstream. The companies involved with pipelines and transportation are described as midstream and refineries and retail companies are described as downstream. For more information on these categories and the oil and gas industry generally, see Practice Note, Oil and Gas Industry: Overview ([w-001-6326](#)). While some companies are “fully integrated,” meaning they are engaged in upstream, midstream and downstream activities, this Note focuses on issues related to upstream-only E&P companies.

By their nature, almost all the value of E&P companies resides in their unproduced oil and gas reserves. Accordingly, most independent, non-integrated E&P companies finance their capital expenditures through reserve-based loans (RBLs). Simply put, an RBL usually consists of a revolving credit facility that is primarily secured by the E&P companies’ oil and gas reserves. An RBL occasionally includes a term loan in addition to a revolver. The maximum amount that may be borrowed under an RBL is governed by a borrowing base that is determined from a periodic (typically twice a year) valuation of those reserves. For more information on RBLs, see Practice Note, Reserve Based Loans: Issues and Considerations ([4-618-2271](#)).

For bigger borrowers, the collateral package in an RBL transaction is sometimes limited to the borrower’s oil and gas assets (reserves and related equipment). Because of the low price of oil and gas in recent years and the resulting reduction in the value of oil and gas reserves, some lenders are requiring these companies to also pledge other assets (for example, stock, deposit accounts, and securities accounts) to enhance the credit and increase the likelihood of repayment. For more information on this requirement, see Article, 2016 Spring Oil and Gas Borrowing Base Redetermination: The Day of Reckoning? ([w-002-2470](#)) and Practice Note, What’s Market: Credit Agreements in the Oil & Gas Industry ([9-525-1178](#)).

While these assets are typically not worth much compared to the oil and gas reserves, their inclusion in the collateral package ensures that in the event of a bankruptcy, the lenders have access to and priority over the borrowers’ more liquid assets. For more information regarding ways to perfect liens and security interests in those more common types of assets, see Practice Note, UCC Creation, Perfection and Priority of Security Interests ([6-381-0551](#)). This Note focuses on financing issues related to oil and gas reserves as collateral for an RBL.

OIL & GAS FINANCING ISSUES

The most important legal issue in oil and gas financing is the recognition that the law regarding ownership and operation of oil and gas is a complex area of statutory and case law.

US law is unique from the rest of the world in that oil and gas may be owned “in place,” a distinction that many believe is the key to the country’s success in exploiting these resources more effectively than others. In fact, “[c]ompared with almost every other oil-producing country in the world, ownership of oil and gas in the U.S. by private parties, often landowners, is an anomaly. . . . [t]he synergy of a capitalist economy and the private ownership of minerals propelled the U.S. to become the world’s leader in exploration and exploitation of oil and gas” (Bernard F. Clark, Jr., *Oil Capital 1-2* (2016)).

In addition, the states differ on how oil and gas reserves may be owned. In most states, it is real property, but in others, it is personal property. Furthermore, the various types of oil and gas ownership can slice these distinctions more finely. For example, two states may consider oil and gas interests as real property generally, but one state may consider a net profits interest (an interest in a percentage

of production after deducting certain costs) in the reserves a personal property interest, while the other state may consider it a real property interest (see Type of Interest Included as Collateral).

For the oil and gas finance attorney, there also is the art and practice of title review and lien coverage. This is the process of verifying that the borrower has title to its properties and filing mortgages or deeds of trust covering those properties. Practitioners who are new to this area are often surprised to discover that:

- Title insurance is not available for oil and gas properties.
- It is often not feasible to confirm title to or file mortgages on 100% of an E&P company's properties. The acceptable percentage for title and mortgage coverage depends on the type of loan and the properties. A lender generally requires a higher percentage for a development loan and a lower percentage for a loan against producing properties. The starting point for discussion between the E&P company and the lender is usually 80%, but as reserve values have fallen since mid-2014, many lenders are increasing this percentage (see Article, 2016 Spring Oil and Gas Borrowing Base Redetermination: The Day of Reckoning? ([w-002-2470](#))).

Full service energy finance law firms typically have one or more specialists certified by the American Association of Professional Landmen who specialize in oil and gas land title and are assisted by oil and gas attorneys. These professionals:

- Review the reserve report.
- Verify the working interest and net revenue interest in each well.

Describing title confirmation as an "art" is intentional because considerable judgment must be exercised in title confirmation, and only someone with a depth of experience can efficiently and effectively understand and assess a producer's oil and gas title. Because an oil and gas interest under any tract of land is normally splintered among many fractional owners, subject to various agreements related to its development that encumber title, perfectly clear title does not truly exist.

Title and mortgage coverage is a moving target. For example, the relative value of mortgaged properties may decrease as reserves are produced or increase as new wells are drilled in existing tracts. Moreover, E&P companies are constantly buying, pooling, swapping, and selling properties within their portfolio. It is therefore important for lenders to continually evaluate their borrowers' collateral, and for the lenders' counsel to remain vigilant in confirming that title and mortgage coverage complies with the requirements set out in the loan documents. This is especially important in a low price commodity environment in which many E&P companies are filing for bankruptcy or are at risk of insolvency.

There are multivolume treatises and law school courses dedicated to these subjects. This Note is limited to describing some fundamental issues regarding oil and gas finance and alerting practitioners to other issues for which experienced oil and gas finance counsel should be sought.

ISSUES IN PERFECTING A LIEN OR SECURITY INTEREST IN OIL AND GAS

The ownership of oil and gas is a hybrid of sorts. That is to say, oil and gas have attributes that relate to both real and personal property. Its classification depends on when and where it is being used as

collateral for financing. E&P lenders therefore must ensure that their security interests and liens have been properly created and perfected to cover the collateral before, upon, and after extraction. There are many issues for E&P lenders and their counsel to consider, including:

- Whether the oil and gas rights are real property or personal property (see Real Property or Personal Property).
- The type of interest that is included as collateral (see Type of Interest Included as Collateral).
- What happens when the oil and gas is extracted (see When Oil and Gas Is Extracted).
- First purchaser statutes (see First Purchaser Statutes).

REAL PROPERTY OR PERSONAL PROPERTY

For real property, a mortgage or deed of trust is required to perfect a lien. For personal property, the Uniform Commercial Code (UCC) governs the perfection of a security interest in personal property. In reserve-based oil and gas finance, both liens and security interests may be relevant depending on how state law treats the property.

There is no uniform rule that can be applied across the states when analyzing the nature of a particular oil and gas interest. The analysis instead requires a thorough review of the applicable law (case law, statutory law, or both) for each state in which the oil and gas is situated. Moreover, production of oil and gas on Federal and Indian lands and the Outer Continental Shelf is governed by Federal law. See Rocky Mountain Mineral Law Foundation, *Law of Federal Oil and Gas Leases, Vol. 1*, §1.01 (Matthew Bender & Co. 2016).

Certain jurisdictions have statutorily classified oil and gas rights as realty or personalty for particular purposes, in which case the statute governs. For example, in Colorado, the statute states that any conveyance, reservation, or devise of a royalty interest in minerals resources, contained in any instrument executed on or after July 1, 1991, creates a real property interest (Colo. Rev. Stat. § 38-30-107.5). Another example would be New York's Lien Law, which provides that for purposes of the New York Lien Law, the term real property includes "all oil or gas wells and structures and fixtures connected therewith" and "any lease of oil lands or other right to operate for the production of oil or gas upon such lands" (N.Y. Lien Law § 2).

Even within the same state, oil and gas interests may be real property or personal property depending on the context. In many states, the legal characterization of oil and gas interests remains uncertain based on existing case laws. For example, in Texas, while several courts have held that net profits interests are interests in land, there has also been one case in which the court held in dictum that a net profits interest is merely a contractual right (see *Le Bus v. Le Bus*, 269 S.W.2d 506, 511 (Tex. Civ. App. 1954)).

On the other hand, oil and gas once produced is no longer part of the land and therefore is classified as personal property. After oil or gas is produced and becomes personal property, even if reinjected back into the ground for storage, the oil and gas does not revert back to being real property. As personal property, the creation, attachment, and perfection of a security interest is normally subject to the UCC rules for personal property. However, counsel should be cautious of non-uniform code sections of some oil and gas producing states, which are described in more detail below (see First Purchaser Statutes).

TYPE OF INTEREST INCLUDED AS COLLATERAL

Oil and gas collateral could be relatively simple if it consisted entirely of one type of ownership interest. However, this is rarely the case. The “bundle of sticks” in a mineral estate can be divided into various types of oil and gas interests (see Upstream Oil and Gas Company Structure and Players Flowchart ([w-002-9625](#))). Each of these interests is subject to encumbrance and alienation, and a borrower may subject any or all interests to a single encumbrance. A borrower may also have numerous entities hold different interests that are subject to different encumbrances. One collateral package for a single loan transaction therefore may include as collateral oil and gas interests that are not only of different types but that also arise out of different oil and gas properties.

The process of fractioning the mineral interests normally begins with the landowner granting a lease to an E&P company proposing to drill the land for oil and gas. When entering into an oil and gas lease:

- The lessor typically retains a royalty interest in the oil and gas.
- The lessee owns a leasehold interest (called a working interest).

For more information on oil and gas leases in a leading producing state, see Practice Note, Understanding Oil and Gas Leases (TX) ([w-002-0452](#)).

The lessor may further transfer in whole or in part his royalty interest to his heirs or by sale to one or more third party (see Royalty Interest). The lessee may also decide to assign his working interest in whole or in part to a third party under an assignment, farm out agreement, or several other types of conveyances. The lessee may also reserve an overriding royalty interest or assign an overriding royalty interest to investors, lenders, or as an “equity kicker” to a party involved with the project. Ownership of even a small tract of land can lead to multiple conveyances and assignments, resulting in a wide variety of oil and gas interests.

For many of the major oil-producing states, until oil and gas is severed from the ground, the law of real estate mortgages governs perfection and priority of liens, but this rule does not hold true for every type of interest in unextracted oil and gas. For example, as mentioned above, in some jurisdictions in which the oil and gas would be encumbered by mortgages, a net profits interest would be personal property and not subject to the mortgages. The E&P lender therefore must file a UCC-1 financing statement with the office of the secretary of state in the state in which the debtor is located to further perfect a security interest in the net profits interest.

Some of the most common ownership interests in oil and gas include:

- Mineral interests (see Mineral Interest).
- Royalty interests (see Royalty Interest).
- Working interests (see Working Interest (Leasehold Interest)).
- Overriding royalty interests (see Overriding Royalty Interest).

Mineral Interest

A property interest created by an instrument that transfers (by a grant, inheritance, assignment, reservation, or otherwise) an interest of any kind in oil and gas in the ground is referred to as a mineral interest or mineral estate.

Since most oil and gas conveyances are potentially perpetual in nature, a mineral interest is generally considered real property.

A mortgage or deed of trust therefore is usually utilized in granting an oil and gas lien. For the oil and gas lien to be enforceable against third parties and to have priority over competing claims, the lender must put third parties on notice of its lien by recording the mortgage or deed of trust in accordance with the state’s recording statutes. In Texas, to create a valid lien in oil and gas that can be foreclosed upon with priority over other claims, the lender must file a deed of trust that properly identifies the oil and gas in question in each county where the oil and gas reserves serving as collateral are located. For more information on this type of interest, see Practice Note, Oil and Gas Law: Overview (TX) ([w-002-1943](#)).

Royalty Interest

A royalty interest is a cost-free share of production that the lessor of an oil and gas lease almost always retains in exchange for granting the lessee the right to explore for, develop, and produce the minerals. The royalty interest holder bears none of the costs and expenses associated with the exploration, production, and development of the minerals.

In Texas, a royalty interest is generally considered realty and not subject to Article 9 of the UCC (Article 9) unless the minerals are produced. The E&P lender therefore must follow the Texas real estate mortgage laws to secure its lien in a royalty interest. However, not all states classify a royalty interest as real property. For example, in Kansas, a royalty interest is considered personal property.

Working Interest (Leasehold Interest)

A working interest (or leasehold interest) is a percentage of ownership in an oil and gas lease (an operating interest) that grants its owner the right to explore and produce oil and gas from the property. The working interest owner pays the costs of E&P exploration, development and operations.

In Texas, a working interest in oil and gas is considered an interest in real property rather than personalty. For purposes of using working interests as collateral, E&P lenders should follow Texas real estate mortgage rules. This is the general rule in many of the major oil-producing states.

Other states take a different approach. In Pennsylvania, the legal characterization of a working interest depends on what rights are being conveyed by the oil and gas lease (see *Chesapeake Appalachia, LLC v. Powell (In re Powell)*, 2015 WL 6964549 (M.D. Pa. 2015)). In Kansas, a working interest is generally considered personal property unless specifically classified otherwise by statute (see *Utica Nat'l Bank & Trust Co. v. Marney*, 661 P.2d 1246, 1247-48 (Kan. 1983) (stating that “the rights created by oil and gas leases covering land in Kansas constitute intangible personal property except when that classification is changed for a specific purpose by statute” (emphasis in original)) (quoting *Ingram v. Ingram*, 521 P.2d 254, 419 (Kan. 1974))). Therefore, when dealing with working interests in Kansas, the E&P lender generally must follow the UCC.

Overriding Royalty Interest

An overriding royalty interest is a cost-free share of production carved out of the working interest, typically by assignment or reservation. An overriding royalty interest generally entitles the owner of the interest to a specified share of the oil and gas produced under the terms of the lease.

In Texas and in many other oil-producing states, overriding royalty interests are generally treated as interests in real estate. The notable exceptions are Kansas and Oklahoma, where an overriding royalty interest is considered personal property (see Patrick H. Martin and Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law*, § 214 (Matthew Bender & Co. 2016)). In states where these interests are considered real property, E&P lenders should follow real estate mortgage rules. In Kansas and Oklahoma, a UCC-1 financing statement must be filed to perfect the E&P lender's security interests in those properties.

An overriding royalty interest can be further classified as:

- **A net profits interest.** This is a non-operating mineral interest that takes a share of the proceeds of production that is measured as a percentage of the net profits derived from the relevant well or group of wells. A net profits interest owner:
 - does not receive any distribution when there are insufficient gross proceeds from the operations of the well in any period of calculation to offset the expenses attributable to that calculation period; and
 - is not liable to cover any shortfalls when the operations of the well are unprofitable.

The classification of net profits interest as realty or personalty is somewhat unclear in several states. There is a lack of case law addressing this issue, and the court holdings are inconsistent in some states (for example, Texas). Therefore, the provisions of the instrument that created the net profits interest should be reviewed to assist in determining the nature of the interest.

- **A production payment.** This is a cost-free share of production that terminates when the owner of the production payment is paid a given volume of production or a specified sum from the sale of the oil. As most commonly employed, production payments are a type of overriding royalty interest and normally follow their legal treatment. However, the term "production payment" can have different meanings depending on context. For example, in the bankruptcy realm, a production payment is considered a type of term overriding royalty, which is "(A) contingent on the production of a liquid or gaseous hydrocarbon from particular real property; and (B) from a specified volume, or a specified value, from the liquid or gaseous hydrocarbon produced from such property, and determined without regard to production costs." (11 U.S.C. § 101(42A).) The phrase "term overriding royalty" is defined as "an interest in liquid or gaseous hydrocarbons in place or to be produced from particular real property that entitles the owner thereof to a share of production, or the value thereof, for a term limited by time, quantity, or value realized" (11 U.S.C. § 101(56A); see *Tow v. HBK Main St. Invs., L.P.* (*In re ATP Oil & Gas Corp.*), 2015 WL 1093568 (Bankr. S.D. Tex. Mar. 10, 2015) (reviewing potential risks when courts apply various definitions of production payment)).

Other interests related to oil and gas include:

- Future interests.
- Reversionary interests.
- Covenants running with the land.
- Interests arising out of mutual interest agreements.

- Interests arising out of farm out agreements or joint operating agreements.
- The right to receive lease bonus payments.

These interests can also be characterized as real property or personal property depending on the jurisdiction. The E&P lender therefore must conform the documents to the applicable law. If the interest in question is real property, then generally a mortgage must be filed to create a lien on the property in accordance with the real estate mortgage laws. If it is personal property, then a UCC-1 financing statement must be filed to perfect the E&P lender's security interests in those properties in accordance with the UCC provisions for perfecting security interests in personal property generally, though each applicable jurisdiction should be checked for non-uniform provisions of the UCC.

In addition, reserves and the related fixtures and personal property interests can be located in many jurisdictions (counties or parishes) or on federal or tribal lands. A lender will likely file and record its collateral documents in all potentially applicable records and offices.

WHEN OIL AND GAS IS EXTRACTED

As oil and gas is extracted, it:

- Is no longer considered in the ground.
- Ceases to be realty (if it was realty previously).
- Becomes personal property, at which point Article 9 comes into play.

Oil and gas, once extracted, therefore become goods and eligible to be collateral or as-extracted collateral under Article 9.

The term "as-extracted collateral" is defined as "oil, gas, or other minerals 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" (UCC § 9-102(a)(6)(A)).

As-extracted collateral is different from other oil and gas collateral because the debtor must have had an interest in the oil and gas before extraction and the E&P lender's security interest attaches to the oil and gas as they are extracted. The term also includes "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" (UCC § 9-102(a)(6)(B)). The right to receive proceeds from the debtor's sale of extracted oil and gas therefore would constitute as-extracted collateral if the debtor-seller had an interest in the oil and gas before extraction.

The local law of the jurisdiction in which the wellhead is located governs perfection, the effect of perfection or nonperfection, and priority of a security interest in as-extracted collateral (UCC § 9-301(4)). States may have special UCC provisions for as-extracted collateral that diverge from the uniform UCC perfection scheme, in which case the special UCC provisions govern.

For example, the Texas Business and Commerce Code (TBCC) includes a non-uniform statute. To properly secure a security interest against most types of personal property in Texas, the creditor must file a UCC-1 financing statement with the Texas Secretary of State's office. However, a security interest in as-extracted collateral is perfected in Texas by filing a UCC-1 financing statement in the county

clerk's office of the county in which the as-extracted collateral is located (Tex. Bus. & Com. Code Ann. § 9.501(a)). Alternatively, in Texas, a mortgage properly drafted can also serve as a financing statement filed against the as-extracted collateral (Tex. Bus. & Com. Code Ann. § 9.502(c)). In that case, a mortgage that is being utilized to perfect a lien on the oil and gas in the ground remains an effective security interest as a properly filed financing statement regarding the as-extracted collateral.

FIRST PURCHASER STATUTES

Several oil-and-gas-producing states, such as Texas, Kansas, and Oklahoma, have enacted non-uniform amendments to Article 9 with unique provisions, such as special filing rules that allow an E&P lender to perfect its security interest in oil- and gas-related personal property by following the jurisdiction's real estate recording acts instead of Article 9. Those rules provide convenience to E&P lenders because virtually every secured E&P loan would inevitably involve real estate records and a mortgage, but having non-uniform Article 9 provisions adds another layer of confusion when E&P lenders are executing RBL transactions.

To better protect oil and gas producers and interest owners against oil and gas purchasers defaulting in payment of the proceeds of production, several states have put in place statutes that elevate them to purchase money security interest holders under certain circumstances. In Texas, for example, a provision of the TBCC grants oil and gas producers and interest owners with an automatically perfected purchase money security interest in the first purchaser's rights to oil and gas production or its proceeds. A handful of other states have similar provisions that give the interest owners' lien the status of a purchase money security interest for priority purposes, but some require the interest owner to perfect the lien by filing an affidavit of production. It is therefore crucial for E&P lenders to understand the subtle differences between each state's non-uniform provisions regarding priority, perfection, and duration of the security interest. For further illustration of the importance for secured lenders to evaluate the status of their security interests, see *Mull Drilling Co., Inc. v. SemCrude, L.P. (In re SemCrude L.P.)*, 407 B.R. 82 (Bankr. D. Del. 2009); *Arrow Oil & Gas, Inc. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 112 (Bankr. D. Del. 2009); *Samson Res. Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 140 (Bankr. D. Del. 2009)).

OTHER ASSETS INCLUDED IN THE COLLATERAL PACKAGE

The development of oil and gas leases is capital-intensive and requires high-technology equipment, such as seismographs, drilling rigs, casing pipes, wellhead equipment, and storage tanks. This equipment is normally included in the collateral package of an RBL transaction. Depending on the items being included as collateral, the equipment is either real property, equipment, or fixtures for perfection purposes. Improvements made to the oil and gas property are normally classified as realty under state law and therefore subject to the state's mortgage rules. The E&P lender can perfect its security interest in equipment by filing a UCC-1 financing statement with the Secretary of State of the jurisdiction where the debtor is located. However, many practitioners would, in addition to the central filing, also make local filings in the county where any wellheads are located. If the collateral is classified as a fixture, E&P lenders should follow the UCC and file fixture filings in each county where fixtures may be located. Article 9 also provides that a real estate mortgage is effective from the date of recording as a financing statement filed as a fixture filing as long as:

- The record indicates the goods it covers.
- The collateral is or is to become a fixture related to the real property.
- The record otherwise satisfies the requirements of a financing statement.
- The mortgage is duly recorded.

(UCC § 2-314.)

Like any operating entity, an oil and gas company has personal property, such as contracts, deposit accounts, securities accounts, stock, intellectual property, and intangible rights. These assets often have a low value compared to the reserves, so traditional secured lending practices must be examined with a cost-benefit analysis. For example, E&P companies may not have any value in intellectual property. Although this type of collateral may have little to no value, counsel should secure all assets of the E&P company for an RBL. For more information on perfection of the security interest in these other assets, see Perfection Steps Checklist ([2-382-8845](#)).

ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

If you are not currently a subscriber, we invite you to take a trial of our online services at legalsolutions.com/practical-law. For more information or to schedule training, call **1-800-733-2889** or e-mail referenceattorneys@tr.com.