IOC MINERAL CONTRACTOR’S LIEN SCRIPT

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Narrator: Overleveraged Exploration, LLC, a Delaware LLC with its principal office and operations in the Southern District of Texas, has filed a chapter 11 case in the District of Delaware. The Unsecured Creditors’ Committee Counsel has undertaken a lien analysis and, for the convenience of the parties who cannot meet in the inconvenient forum of Wilmington, DE, has arranged a conference call with the secured lender and various mineral contractors involved in the J.R. Ewing #1 Well.

By way of background, Overleveraged has oil, gas and mineral leases with various lessors owning mineral interests in a 640 acre Unit in Dimmit County, Texas. It had acquired some of the leases by assignments from other companies who retained some of the working interest.

As a result, at the time the J.R. Ewing #1 well was “spudded”, Overleveraged had an 80% working interest in the leases, and the remaining 20% working interest was owned by other companies. Prior to commencement of operations, Overleveraged, as Operator, entered into a Joint Operating Agreement (“JOA”) with the other working interest owners, who were the Non-Operators. The J.R. Ewing #1 was the Initial Test Well under the JOA, and as such, the Operator and Non-Operators were all obligated to participate in the costs of drilling, completing and operating in accordance with their percentage working interests in the Unit.

Overleveraged entered into a drilling contract with Tighthole Drilling, which, in turn, contracted with various service companies to perform the work, including Dryhole Mud Company, Rathole Service Company and Slimhole Completion Co. Tighthole Drilling did not get around to having the Non-Operators sign the drilling contract.

Overleveraged had a $20 million dollar line of credit with New York Bank, which was secured by Overleveraged’s 80% working interest in the J.R. Ewing #1 Unit. The Bank filed a Deed of Trust and Security Agreement and UCC fixture filing with the County Clerk of Dimmit County, and UCC financing statements with the Secretaries of State of Texas and Delaware. But New York Bank is hardly Overleveraged’s only creditor. The vast majority of the company's debt is in the form of bonds owned by a plethora of mutual funds, hedge funds, and other institutional investors.

Although the J.R. Ewing #1 was ultimately completed as a producer, Tighthole Drilling ran into one problem after another and exceeded its AFE budget by 50%, Overleveraged maxed out its line of credit and had millions in unpaid bills from Tighthole, which in turn could not pay its subcontractors. Meanwhile, oil and gas prices plummeted, there were delays in getting the well connected with a pipeline and J.R. Ewing, the owner of the tract where the well was drilled, filed suit because of a release of toxic drilling fluids onto his property from a tank truck.

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Comm. Counsel: As you probably are aware, I am the lead counsel for the unsecured creditors committee in the Overleveraged case. I have arranged this call to discuss our assessment of your liens, and the problems I’ve seen in some of your perfection documents. Since all of Overleveraged’s wells are in Texas I have analyzed your lien perfection documents and lien priority under Texas law.

NY Bank Counsel: Just so you’ll know, I represent the largest energy lender in the world. It has superior, perfected first liens and security interests in all of the Debtor’s assets. Frankly, this is a waste of my valuable time. More importantly, I have a squash match at the Harvard Club in 45 minutes, so make it quick.

Rathole: Hey now, you folks with “New York Values” may think you own the nation, but we Texas service companies know our stuff and, by the way, we’ve got you beat smarty pants. And by the way, it is total bull\_\_\_\_\_\_ that is case was filed in some little ole state up East when the well is in Texas, and your borrower and all of us who drilled the well are from Texas.

Comm. Counsel: I understand your concerns, but venue of this case is proper in Delaware since it is the state of incorporation of Overleveraged. So I’ll address your liens in an orderly fashion and if you don’t mind, I’ll begin.

All of you have been provided with the attached document which I’ll call your “report card”. I’ve reviewed your report card, and now it’s time for your grades. Of course I’ll listen to any comments or responses you may have.

As an overview, since we’re in Bankruptcy, the automatic stay under section 362 of the Bankruptcy Code generally prevents actions to perfect liens, but there’s an exception for mechanics liens and mineral contractor’s liens. If you have a well drilled in a state like Texas, where the lien relates back to the date of the “inception” of the lien, under Bankruptcy Code § 546(b), a lien affidavit or other perfection document may be filed after the bankruptcy case is filed without violating the stay.

NY Bank Counsel: My client filed first, and in every local or state office required by law. End of story.

Dryhole Mud: Not so fast. I wonder if your bankers actually went out on the site to see if the work on the well had already commenced.

NY Bank Counsel: Why would my client actually go to some dreary wellsite in the middle of nowhere?

Comm. Counsel: Well, you’re getting ready to find out. But let’s first get the facts down. Dryhole, my notes reflect you delivered drilling mud to the wellsite on April 1, 2015. What else was going on at that time.

Dryhole: We decided to get there early. But there were board roads being delivered, surveyors were staking the well site and it was really going and blowing.

Rathole: You got that right Dryhole, my boys at Rathole Service got there first and started laying boards and staking the location before anyone else, on March 20, 2015.

Tighthole: We had our rig on the site on March 25, and spudded the well on March 31.

Comm. Counsel: And that’s why New York Bank may have a problem.

NY Bank: What are you talking about, we filed first, on March 30, and I mean everywhere. I don’t know about these subcontractors, but I know Slimhole didn’t file its lien affidavit in Dimmit County until after this case was filed.

Comm. Counsel: But that’s not the point. If the inception of a mineral contractor’s lien predates your filing date at the County Clerk’s office, under Texas law you’ve got a problem.

NY Bank: Why does Texas law control?

Comm. Counsel: Because in a bankruptcy case, state law defines the nature and extent of the Debtor’s property ownership and the validity and priority of liens, subject, of course, to the Debtor’s powers to avoid liens under Chapter 5 of the Bankruptcy Code.

I’ve brought in my associate to give you some background that will help you understand my analysis of your lien perfection.

Associate: I could cite a lot of cases, but the 5th Circuit summed up the law on Texas mineral contractor’s liens in *In re Heritage Consolidated, LLC* so I’ll pretty much quote it verbatim:

In Texas, material liens are creatures of statute, granted to “both mineral contractors and mineral subcontractors to secure payment for labor or services related to mineral activities, as therein defined.”

Texas courts have repeatedly noted that the mineral lien statute is “designed to protect laborers and materialmen” and should therefore be liberally construed.

While the Texas statute calls these liens “mineral” contractor or subcontractor liens, the case law frequently refers to them as “material and mechanics” or “M&M” liens. Laborers are sometimes referred to as “materialmen” in the case law. These terms appear to be interchangeable.

A mineral contractor is a person who “furnishes or hauls material” or “performs labor” under an express or implied contract with a mineral property owner or with a trustee, agent, or receiver of a mineral property owner. Tex. Prop. Code Ann. § 56.001(2). A mineral subcontractor is a person who “furnishes or hauls material” or “performs labor” under a contract with a mineral contractor. Tex. Prop. Code Ann. § 56.001(4).

Contractors and subcontractors are treated interchangeably under the mineral lien statute, with two notable exceptions: First, subcontractors must give notice to the mineral owner when filing material liens, whereas contractors have no notice requirement.

Second, contractors must have a contractual relationship with a mineral owner, whereas subcontractors only need to have a contractual relationship with a contractor.

When determining whether a laborer is a subcontractor or a contractor, the important question is whether there is a *contractual relationship* between the owner and the laborer performing the work:

If there is a direct contractual relationship between an owner and the laborer, then the laborer is a contractor with regard to that owner. If there is a contract between the laborer and another party who has a contract with an owner, then the laborer is a subcontractor.

If a well has multiple owners, it is possible for a single laborer to be both a subcontractor and a contractor for the work they perform on that well. For example, the owners may collectively enter into an agreement that makes one owner the well operator, and gives that owner-operator the power to contract with laborers. The laborers would then be contractors with respect to the contracting owner-operator, but subcontractors with respect to the other owners.

(“In the typical transaction, the operator contracts directly with vendors but the non-operators do not. A service company contracting with the operator is a contractor as to the operator (if the operator owns an interest in the lease) but a subcontractor as to non-operators.”). It is thus not only possible, but common within the industry for an owner to also be a contractor as defined by the statute.

Under these circumstances, “the service company would need to perfect its lien both ways, first as a subcontractor and second as a contractor” to secure a claim against all owners.

Comm. Counsel: Now that we have the basic law, let’s apply it to the facts. Slimhole is a Contractor as to Overleveraged, but it is a subcontractor as to the other working interest owners because it has no contract with them.

Dryhole, Tighthole and Rathole are subcontractors as to Overleveraged and the other working interest owners because they do not have a contract with any owner but they do have a subcontract with Slimhole. Now we’ll look at the difference in perfection requirements for contractors and subcontractors.

Associate: If you’ll all look at the mineral lien contractor “report card” we’ve handed out, you can see the requirements for perfection of contractors’ and subcontractors’ liens. The primary difference is that while the contractor need only file his affidavit, the subcontractor must serve each owner with a written notice by certified mail at least 10 days prior to filing a lien affidavit and the affidavit must state:

The name of person for whom labor was performed or material was furnished or hauled

And contain a statement that subcontractor timely served written notice that a lien is claimed on the property owner or the owner’s agent, representative or receiver.

Otherwise the requirements for the contents of the lien affidavit are the same for both contractor and subcontractor.

Comm. Counsel: Ok, let’s start with Slimhole Drilling. I’ve examined your lien affidavit and it complies with all the requirements of the Property Code to perfect a lien on the Debtor’s working interest in the well. However, because you never obtained the signatures of the other working interest owners, you are a subcontractor as to them, and as such, you had to comply with the additional requirements of notice and the lien affidavit applicable to subcontractors, which you failed to do. I only care about the Debtor, so you’re perfected as far as it is concerned.

Slimhole: So I guess I can’t go after those working interest owners who aren’t in bankruptcy. Darn, I need a new attorney!

Comm. Counsel: Rathole, frankly you didn’t do much right. While your affidavit would satisfy the requirements for an original contractor, yours didn’t contain the magic words required by the statute that you gave written notice to all owners at least 10 days before filing your affidavit; and you have no proof that you gave written notice to the Debtor, so you’re unsecured.

Rathole: Hey Slimhole, when you find a decent attorney, let me know!

Dryhole: Counsel, let me take the words out of your mouth: I get an A. I’ve gone down the checklist and I got it all right. And frankly, I should get paid in full because if I hadn’t completed that well there wouldn’t have been any production at all.

Comm. Counsel: You’re right, I’m surprised that anyone from Dime Box, Texas could follow the law so well, but you did except for one thing: you didn’t send your demand notice to the Debtor’s correct address and your certified green card was returned undelivered. The address you used was correct at one time, but unless you can show that this was the address on your contract or you were told to send notice to that address by the Debtor, you may have a problem. But since Texas courts construe mechanics’ lien laws liberally in favor of the laborer, I’ll give you the benefit of the doubt.

Now to Dryhole: You get an A-. You even sent your notices to the registered agents of all the working interest owners as well as to their principal offices. The property description you used was not the proper legal description in all respects for the Well site or Unit, but while there might be an argument against you, in the end I think the Court would find the description adequate. Just remember, a legal description must be sufficient for a surveyor to use it and locate the property on the ground.

New York Bank: While I’m sure I should be appreciative of this legal bull session, frankly I’m going to miss my squash game if you don’t get around to me and congratulate me on having a prior perfected lien that wipes out these yokels.

Comm. Counsel: I would call your carrier before going to that game because you do not have a first lien. The inception of a mineral contractor’s lien occurs when work and labor begins or materials are delivered to the leasehold premises. The evidence shows that Slimhole, Dryhole and Rathole began work prior to the date your recorded your lien documents. Even though they didn’t file their lien affidavit until months later, under Texas law, their lien relates back to the inception date when they began the work.

But you’ve got a bigger problem than that. Your legal description includes the drill site tract but leaves out oil and gas leases covering about 200 acres of the 640 acre unit. The statute of frauds requires an adequate legal description of the entire tract, so you’re SOL.

New York Bank: Does SOL mean statute of limitations?

Associate: No but everyone else on this call knows what it means.

Tighthole: Yeah New York, you’re \_\_\_\_\_\_\_\_\_\_\_outta luck!