Inns of court presentation

**Introduction**

Ed Rothberg Narrator

**Narrator** Tonight we will take you behind the scenes at Green Oil as they grapple with surviving the low oil prices. Green Oil is a relatively small exploration and production company headquartered in Houston with properties in Texas and Oklahoma.

Narrator: Introduction of Officers

Angie O. – CEO, Wilma Wildcat. Wilma’s skill at finding oil matches her name “Wildcat”

Angie K. - Risk Manager, Mimi Moneyball As a Risk Manager her function is to be the scapegoat if the company loses money. Moneyball is a Millennial. What else do I need to say?

Mitchell Ayer - New GC, Atticus Finch. Grizzled oil and gas lawyer

Kris Thomas - Land Mgr, Sally Slick Slick is skilled at wining and dining landowners and taking leases. Like many landman she likes to drink a little too much and is not so good on administrative parts of her job.

Timothy Rose – Intern. Timothy is the stepson of Wildcat and she believes hard work will make him a better man.

Scene will be conference room in company HQ

**Wildcat:** I’ve called you together because there is a Board meeting next Monday. They want to know we have done everything we can in case someone files bankruptcy. We are right on the edge. We are announcing ten percent across board pay cuts tomorrow. We will need to cut more if we take losses. Heads are going to roll if we haven’t done everything that we can. Moneyball: You are responsible for managing risks. What are our biggest risks?

**Perfecting Producers Liens**

**Moneyball:** One of the biggest risks is with our marketing agreements-that we will get stiffed on the sale of our oil like Semcrude did to us.

**Intern: H**ow did SemCrude stiff us?

**Moneyball:** After we extract the oil or gas, companies typically buy the oil or gas at the wellhead, from local tanks located on the leased premises, or at nearby market centers. These companies are called first purchasers. First purchasers often (particularly in the case of oil) transport the products for temporary storage before reselling to downstream purchasers, such as refiners or commodities traders. Consequently, each party involved in the various transactions is paid on a different timeline, resulting in open balances between one party and another at different points of the process.

The timeline for payment under oil and gas sales contracts depends on nature of the interests involved

Producers are customarily paid by first purchasers on either the 20th day or 25th day of each month for oil or gas produced in the previous calendar month. Thus, most producers like us have essentially extended credit for 50 to 56 days of production.

Semcrude filed bankruptcy in Delaware on the 25th day of the month without paying us for the previous month. So Semcrude stiffed us on 55 days of production -30 days on previous month and 25 days when it filed. Green Oil lost over a million dollars

But we weren’t done being screwed. There is a Texas producer’s lien that is supposed to protect sellers like us and is automatically perfected if you have a lease on file. But the bankruptcy court for the District of Delaware held Texas statute was a non standard UCC provision. And we needed to file a UCC to have priority over the secured lender. The legal mumbo jumbo was that that a producer’s lien was subordinate to a secured lender’s lien because the Texas producer had not filed a UCC-1 in the state of incorporation of the purchaser of the production prior to the secured lender’s lien.[[1]](#footnote-1) The lower priority resulted in the loss of approximately $57 million to Green Oil and the other Texas owners’ interest in the oil and gas proceeds.[[2]](#footnote-2)

**Wildcat:** Atticus what can we do about this risk?

Following bankruptcies of Basin, Inc., Brio Petroleum, Inc., Compton Petroleum Corp., and Gratex Corp. in 1982, several states enacted statutory producers’ liens.[[3]](#footnote-3) Texas,[[4]](#footnote-4) Oklahoma,[[5]](#footnote-5) New Mexico,[[6]](#footnote-6) Kansas,[[7]](#footnote-7) and North Dakota[[8]](#footnote-8) have enacted statutes that grant royalty owners, producers and other oil and gas interest owners a statutory security lien to secure payment of the purchase price for that production.[[9]](#footnote-9) Importantly certain states allow these security interests to be treated as purchase money security interests (“PMSI”).[[10]](#footnote-10) However for these liens to be enforceable over the secured lenders they ned to be properly perfected

**Intern:**  How does a PMSI work here?

**Atticus** A PMSI is a security interest or claim on property that enables a lender who provides financing for the acquisition of goods or equipment to obtain priority ranking ahead of other secured creditors. Because the producer is the one actually furnishing the goods in this case the oil or gas, it is logical that producer have a PMSI in such goods and the proceeds of their sale. However, before a party may take advantage of the super priority of such producer’s liens, those liens must be made effective against third parties But as Moneyball was telling you about Semcrude, if there is no UCC and there is a secured lender the statutory lien is worthless.

Thus, in order to ensure the best priority for the Texas producer’s lien, producers who are selling on credit should file a UCC-1 in the state of incorporation of the first purchaser of the production rather than rely solely on automatic perfection.[[11]](#footnote-11) Although a recent check of UCC records shows this advice is not being followed, the lessons learned from large purchasers such as Enron and Semcrude show that it needs to be done regardless of the size or reputation of the purchaser of production.[[12]](#footnote-12)

**Wildcat:** So what does that cost to file a protective UCC?

**Atticus:** Capitol Services charges $125 to file a UCC-1 in Delaware[[13]](#footnote-13).

**Wildcat:** Tim Get ‘er done.

**Intern:** Yes ma’am What about our Oklahoma properties?/

**Slick:** I thought the Oklahoma legislature fixed its producers lien statue after Semcrude.

**Atticus:** Yes. The Oklahoma legislature passed legislation seeking to correct the Semcrude problem. But that has not yet been tested by the courts. I recommend you file a protective UCC to perfect the Oklahoma statutory lien also.

**Wildcat:** Atticus do you have an example of one?

**Atticus** Yes I do.

**Narrator:** A form of such along with memorandum of operating agreement is included in the materials which will be posted on our website.

**Wildcat:** Good, Tim - get those on file before Monday

**Perfecting Operator’s and non –operator’s liens,.**

**Wildcat:** Moneyball what is the next risk?

**Moneyball:** That our working interest partners won’t pay their share of costs to drill and Frack.

**Wildcat:** Slick, what are you doing about that?

**Slick:**  If the joint operating agreement provides we require our partners to prepay drilling and fracking costs.

**Intern:**  What’s an operating agreement? A JOA is an “agreement between or among interested parties for the operation of a tract or leasehold for oil, gas and other minerals,” by which “[t]he parties to the agreement share in the expenses of the operations and in the proceeds of development.”[[14]](#footnote-14) It is important to note that “the agreement normally is not intended to affect the ownership of the minerals or the rights to produce,” and, thus, the JOA does not create a separate entity, distinct from the working interest owners who are parties to the agreement.[[15]](#footnote-15) Consequently, working interest owners must include provisions in the JOA that allocate drilling and production risks among themselves

Intern: How much does it cost to drill and frack a well

Moneyball: Can run ten million dollars depending on the number of frack stages.

**Wildcat:** Prepaying sounds good. Can we do anything else?

**Atticus: .** The American Association of Professional Landmen AAPL has model forms that are universally used with some modifications. As an exhibit to the model form is a memorandum of JOA which is to be filed in the county records when the JOA is executed to perfect the operator’s and non-operator’s liens. Likewise a UCC should be filed to perfect operators and non operators liens in production and proceeds.

**Wildcat:** Slick, has the land dept. got those on file?

**Slick:**  I’m not sure. My job is to get the leases. I thought the folks in file setup did that?

**Wildcat:** Atticus is it too late to get those on file now?

**Atticus:** Yes and no. if the working interest partner files in 90 days it can be set aside as a preference. But typically when we find out a company is having problems we have more than 90 days before they work out their deal with the lenders, get a stalking horse sale and get a bankruptcy on file.

**Slick:**  Atticus, do you have sample of that?

**Atticus**  Yes

**Wildcat:** Good. Tim get those on file before Monday

**Moneyball:** But what if the working interest partner already has a senior lien

**Atticus:** In that case first in time takes priority.

**Wildcat:** Are you kidding me You mean we could lose a $2 million payment because we didn’t file a memo of operating agreement.?

**Atticus:** Yes. Without a perfected lien or security interest, a party to the JOA will have a mere unsecured claim for another working interest owner’s share of production and drilling costs under the agreement

**Moneyball**: There has to be something else. They are going to have my head. Atticus give us some help here.

**Atticus:** Well There are two other possibilities: Recoupment and assumption of operating agreement

**Wildcat:** How does recoupment work?

A contractual risk-mitigation principle related to setoff is recoupment. Setoff applies to mutual debts between the same parties standing in the same capacity, but does not require that the debts arise out of the same agreement. Recoupment, on the other hand, is the netting of obligations within or among the same agreement.[[16]](#footnote-16) Thus, recoupment is more narrowly applied.[[17]](#footnote-17) However, recoupment is not subject to the automatic stay.[[18]](#footnote-18) Therefore, a contract counterparty should consider whether the netting of amounts owed to and owed by a debtor are so closely tied together contractually that recoupment, not setoff, may be applicable. Texas bankruptcy courts have held can recoup costs if in same contract area of the JOA.

**Moneyball:** What’s that second thing-- about assuming JOA?

**Narrator** Typically the bankrupt entity will sell its oil and gas assets. The buyer will want an operating agreement in place. As bankruptcy attorneys know assumption and assignment requires that any defaults or payments due need to be cured. That would solve the problem.

**Moneyball: L**et’s hope any partners sell their assets and assume the JOA/s

**Slick:** I’ll drink to that!

**Perfecting** Non-Consent Interests by Memo of JOA or Taking Subject to JOA

**Wildcat:** What about protecting our non consent interests? What happens in bankruptcy?

**Intern:**  What’s a non consent interest?

**Atticus** The model form JOA provides for a working interest partner that does not participate in an operation to pay a risk premium typically of 300 percent of the cost of the operation before they can be paid on any production fro the well. A Texas Court of Appeal held that such a non-consent interest was not part of the Debtor’s estate as it fell into the safe harbor of a farmout agreement. That was the Trans Texas v Forcenergy case. But in order for that to work need to have a memo of JOA on file or have JOA of counterparty in chain of title.

**Moneyball:** What if working interest partner has senior lien. What happens to getting our non consent interest?

**Atticus T**he rule is first in time is senior. Either memo of JOA or interest being taken subject to JOA in chain of title needs to be prior to date secured lender’s liens is recorded.

**Wildca**t: So you mean we could lose 200 percent non-consent interest because somebody didn’t file JOA/ AAAARRGHHH

**Atticus:** Yes but will be able to recoup actual costs.

**Wildcat;** This memo of JOA is critical. Moneyball you need to put a system in place that we can’t drill a well without being sure a memo of the JOA is in place. We may also need to get a subordination from the lender..

**Wildcat:** Atticus, anything else we should do?

**Forced Pooling Liens in Oklahoma and Other States.**

**Atticus** Yes. In some states like Oklahoma and North Dakota, that have forced pooling. The parties often don’t need JOAs but rely on the forced pooling order that sets the nonconsent penalties and operator’s liens for payment. But in Oklahoma courts have held in order to have a perfected lien, need to file an affidavit with pooling order of record.

**Wildcat:** Slick, has the Land Dept. got those on file?

**Slick:** I’m not sure. Given the way the rigs were throwing out AFE’s we didn’t have time to do that. I thought file setup did that

**Wildcat;**: Atticus Do you have a sample of that form?

**Atticus**  Yes.

**Wildcat:** Good. Tim get those on file before Monday. Atticus anything else you can think of.

**Atticus:** Yes If we are the non-operator and have right to exercise an option to take I n kind, you might think about exercising that option if it otherwise makes sense.

**Slick:** Why is that?

**Atticus:** That serves to reduce the risk that the operator will get paid on your production and not pay you.

**Wildcat**: Tim check that out by Monday

**Moneyball** We have some pretty big leases, what happens if the lessor files bankruptcy can he reject the lease.

**Atticus:** In states like Texas an oil and gas lease is not considered a true lease but a transfer of a real property interest. Therefore don’t need to worry --can’t be rejected. There may be some other surface agreements Debtor might reject but not the oil and gas lease itself.

**Slick: W**hat about leases in other states where it is considered a true lease.

**Atticus: T**hat should not be a problem either because a Pennsylvania court has held even if rejected the lessee is entitled to the safe harbor under Section 365 to remain as lessee for the term of the lease.

**Narrator:** Any questions?

1. Samson Res. Co. v. SemCrude, L.P. (*In re* SemCrude, L.P.), 407 B.R. 140, 158 (Bankr. D. Del. 2009). [↑](#footnote-ref-1)
2. *Id.* at \_\_. [↑](#footnote-ref-2)
3. *See generally* Terry I. Cross, *Oil and Gas Product Liens—Statutory Security Interests for Producers and Royalty Owners Under the Statutes of Kansas, New Mexico, Oklahoma, Texas and Wyoming*, 50 Consumer Fin. L. Q. Rep. 418 (1996). [↑](#footnote-ref-3)
4. Tex. Bus. & Com. Code Ann. § 9.343 (West 2011). [↑](#footnote-ref-4)
5. Okla. Stat. Ann. tit. 52, §§ 549.1, 549.3 (West 2011). [↑](#footnote-ref-5)
6. N.M. Stat. Ann. §§ 48-9-1, 48-9-3 (West 2003). [↑](#footnote-ref-6)
7. Kan. Stat. Ann. § 84-9-339a (West 2008) Interest owners in Kansas are required to file an “affidavit of production” in the register of deeds of the county where oil and gas produced to perfect security interest. *Id.* § 84-9-339a(b). Like Texas, the security interest in and lien on produced oil and gas is treated as a PMSI for purposes of determining priority relative to other Article 9 security interests. *Id.* § 84-9-339a(h). [↑](#footnote-ref-7)
8. N.D. Cent. Code Ann. § 35-37-02 (West 2008). [↑](#footnote-ref-8)
9. Mississippi grants a lien to royalty owners to secure the payment of the royalty proceeds. *See* Miss. Code Ann. § 53-3-41 (West 2014). Unlike the other liens, however, a producer who is not also a royalty owner would not be protected. *Id.*  [↑](#footnote-ref-9)
10. \_\_. [↑](#footnote-ref-10)
11. Because the producer’s lien was a non-standard UCC provision and no UCC-1 was filed, the court did not need to address the issue of priority based on date of filing which might give the Bank another argument if it filed first. However we do know if a producer does not file a UCC, the secured lender will win. [↑](#footnote-ref-11)
12. \_\_. [↑](#footnote-ref-12)
13. Plus cost of any paralegal time and state charge of $2 per page in excess of four pages. If same purchaser is in multiple states with statutory liens, can file one UCC for multiple states. [↑](#footnote-ref-13)
14. Patrick H. Martin & Bruce M. Kramer, Williams & Meyers, Oil and Gas Law, § 8-J (LexisNexis 2014). [↑](#footnote-ref-14)
15. *Id.* [↑](#footnote-ref-15)
16. Holford v. Powers (*In re* Holford), 896 F.2d 176, 178 (5th Cir. 1990); *In re Brown*, 325 B.R. 169, 175–76 (Bankr. E.D. La. 2005). [↑](#footnote-ref-16)
17. Recently, some courts have applied recoupment even more narrowly. *See, e.g.*, Sacramento Mun. Util. Dist. v. Mirant Ams. Energy Mktg., LP (*In re* Mirant Corp.), 318 B.R. 377, 381 (Bankr. N.D. Tex. 2004) (holding that recoupment should be narrowly applied and that an “overpayment or something like it” such as “harm to a creditor or benefit to a debtor in excess of that contemplated by the Code” must be shown to justify recoupment). [↑](#footnote-ref-17)
18. *In re Holford*, 896 F.2d at 179; *In re* McWilliams, 384 B.R. 728, 729 (Bankr. D.N.J. 2008). [↑](#footnote-ref-18)