

Clients & Friends Memo

Buyer (and its Creditors) Beware: SemCrude District Court Finds That Purchasers Took Oil and Gas Free and Clear of Producers' Liens

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Although almost eight years have lapsed since the chapter 11 cases of Tulsa, Oklahoma-based SemCrude L.P. were confirmed, many of the issues at the forefront of those cases are re-emerging in light of the recent uptick in oil and gas-related restructurings. The SemCrude cases provided useful guidance for oil and gas producers and purchasers to best address the perfection and management of security interests in oil and gas-related collateral. Perhaps of most significance are the lessons SemCrude taught regarding the repercussions of a secured lender's failure to timely perfect oil and gas security interests, especially if producers have a basis for asserting a security interest under state law. The lessons have not stopped: on July 30, 2015, the Delaware district court resolved a dispute between producers and purchasers, and affirmed the bankruptcy court's holding that the purchasers took oil purchased from SemGroup free and clear of the producers' lien, because the purchasers were "buyers for value" or in the alternative, "buyers in the ordinary course."

The recent decline in oil prices and the concurrent instability and volatility in the oil and gas industry, bring these lessons back into the limelight, making it essential for producers and secured lenders to not only evaluate the status of their security interests, but also manage their relationships with first purchasers.

Background: Typical Energy Transaction

Refining oil and gas for sale typically begins with producers leasing mineral rights from mineral interest owners (who may not be the same parties that own the surface rights for a given parcel of land). After producers extract the oil or gas, first purchasers typically buy the oil or gas at the wellhead, from local tanks located on the leased premises, or at nearby market centers or hubs. Although first purchasers could use the oil or gas for their own commercial purposes, they often (particularly in the case of oil) transport the products for temporary storage before reselling to downstream purchasers like refiners or commodities traders.

Each party involved in the transaction is paid on a different timeline, resulting in open balances between one party and another at various points during the process. Mineral interest owners

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are usually paid royalties by producers in accordance with their oil and gas leases. 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. First purchasers are then paid by downstream purchasers pursuant to the terms of their respective agreements.

The multiple parties involved with the production and shipment of oil or gas results in competing interests. Accordingly, it is of utmost importance for producers and secured lenders to protect their interests by actively monitoring their collateral and debtor counterparties. As explained further below, this precise issue came to a head in the SemCrude bankruptcy cases, where producers and downstream secured lenders both asserted perfected security interests over a first purchaser's assets,¹ resulting in a judicial battle over perfection and priority. In SemCrude, J. Aron & Company ("J. Aron") was a downstream commodities dealer that purchased oil from SemGroup, a first purchaser that purchased oil from a variety of sources and places.² J. Aron purchased over \$435 million of crude oil from SemGroup prior to its bankruptcy petition.³ J. Aron thereafter terminated its derivatives contracts with SemGroup and sought to "net" against \$345 million owed to SemGroup and tender the remaining \$90 million owed to SemGroup's bankruptcy estate for a release of all claims by third parties.⁴

The producers argued that J. Aron could not setoff over the producers' security interests.⁵ J. Aron alleged that the producers did not have a security interest, and if they did, it was a subordinate security interest because Oklahoma or Delaware law applied to perfection of the security interest and required the filing of a financing statement.⁶ Furthermore, J. Aron alleged that it was a "buyer for value" that gave value and received collateral without actual knowledge of any security interest, or in the alternative, a "buyer in the ordinary course" that purchased collateral in good faith and in the ordinary course of business without knowledge of the producers' security interests.⁷ In multiple decisions, the bankruptcy court ultimately sided with J. Aron and (a) held that the producers had a subordinate security interest relative to a downstream purchaser who validly perfected its security interest in the debtor's state,⁸ and (b)

¹ See In re SemCrude, L.P., 407 B.R. 140, 144, 147 (Bankr. D. Del. 2009).

² See Defendant's Memorandum in Support of Motion for Summary Judgment at 9, Samson Resources Company, et. al.; Mull Drilling Company, Inc. et. al.; Arrow Oil & Gas, Inc. et al. v. SemCrude, L.P., et al., No. 08-11525 (Bankr. D. Del. Apr. 17, 2009), ECF No. 3732.

³ Id.

⁴ See Exhibit A to Motion for Approval of Stipulation between SemGroup and J. Aron, In re SemCrude, L.P., Case No. 08-11525 (Bankr. D. Del., Nov. 3, 2008), ECF No. 1982-2.

⁵ See Objection to Motion for Approval of Stipulation between SemGroup and J. Aron, In re SemCrude, L.P., Case No. 08-11525 (Bankr. D. Del., Nov. 17, 2008), ECF No. 2138.

⁶ See In re SemCrude, L.P., 504 B.R. 39, 48 (Bankr. D. Del. 2013) adopted sub nom. In re Semcrude, L.P., No. 14-CV-357 (SLR), 2015 WL 4594516 (D. Del. July 30, 2015).

⁷ Id. at 50.

⁸ See In re SemCrude, L.P., 407 B.R. 82, 111 (Bankr. D. Del. 2009); In re SemCrude, L.P., 407 B.R. 112, 140 (Bankr. D. Del. 2009); In re SemCrude, L.P., 407 B.R. 140, 158 (Bankr. D. Del. 2009).

recommended⁹ that the district court find J. Aron to be a “buyer for value” or “buyer in the ordinary course” that took the oil and gas free of the producers’ liens.¹⁰

On July 30, 2015, the Delaware district court adopted the bankruptcy court’s findings and holdings.¹¹ First, the court affirmed the bankruptcy court’s holdings with respect to perfection of security interests – because the debtors were located in Delaware or Oklahoma, the laws of those states governed perfection (and not the laws where the oil and gas were produced), which laws required filing a financing statement in that state to perfect security interests.¹² Next, the court found that J. Aron was a “buyer for value” because it purchased oil and gas in from SemGroup using unsecured credit without actual knowledge of the producers’ purported lien – in fact, even if J. Aron knew where the oil and gas was located and the identity and location of the producers, J. Aron purchased the disputed oil and gas “subject to an express warranty that it was unencumbered.”¹³ Furthermore, the court found that J. Aron was also a “buyer in the ordinary course” because it purchased the oil and gas in good faith, without knowledge of the producers’ security interests, in the ordinary course of business, and not in total satisfaction of a preexisting debt.¹⁴ Specifically, the court found that J. Aron was a person that typically bought oil from SemGroup, which itself typically sold oil, and therefore both parties acted in the ordinary course of business.¹⁵ Furthermore, “oil-for-oil” netting between J. Aron and SemGroup (*i.e.*, cancelling countervailing oil receivables) was an industry standard practice, and although “cross-product” netting was not necessarily standard practice (*i.e.*, cancelling outstanding amounts due for oil with amounts outstanding due for financial derivatives), the abnormality was irrelevant because J. Aron was a buyer in the ordinary course when it entered into the contracts with SemGroup.¹⁶

The foregoing dispute from SemCrude highlights the importance for secured lenders and producers to evaluate the status of their security interests and take actions towards minimizing the risk of any future challenges or related complications. Downstream purchasers of oil and gas that are not providing “new value” to first purchasers for oil and gas should consider measuring their exposure on a gross (instead of net) basis, especially if such downstream purchasers have not perfected their security interests and there is a risk that a producer is in a state that provides for a continuing lien under state law. As discussed below, secured lenders should also take precautionary steps to protect their security interests in oil and gas notwithstanding potential automatic perfection laws.

⁹ When a bankruptcy court hears a non-core issue, its recommendations must be recommended by a district court. See In re Semcrude, L.P., No. 14-CV-357 (SLR), 2015 WL 4594516, at *4 (D. Del. July 30, 2015).

¹⁰ See In re SemCrude, L.P., 504 B.R. at 50.

¹¹ See In re Semcrude, L.P., 2015 WL 4594516, at *16.

¹² Id. at *8–9.

¹³ Id. at *10.

¹⁴ Id. at *11–15.

¹⁵ Id. at *11.

¹⁶ Id. at *11–12.

What Producers and First Purchasers' Secured Lenders Need to Know about Key Oil and Gas States

In an attempt to protect parties involved in the production of oil and gas, five states with significant oil and gas industries—Texas, Kansas, Oklahoma, North Dakota, and New Mexico—have enacted statutes that afford a statutory security interest to mineral interest owners and producers, as well as other interest owners, over any oil or gas produced, to secure payment for that production. Although the laws are comparable among the states, each state law has particular nuances about the perfection, priority, and duration of the security interest.

Notwithstanding the protections afforded under state law, the outcome for determining whether a party has a valid security interest turns on where the debtor is located, which documents were filed by the creditor with the local register for perfection purposes, and other fact-specific circumstances.

New Mexico

New Mexico has enacted an Oil and Gas Products Lien Act, which grants “interest owners” (generally a producer or mineral interest owner)¹⁷ a continuing purchase money security interest in, and lien on, any unpaid oil or gas severed from a production unit to secure payment from the first purchaser. Within 45 days after payment is due under the terms of the applicable agreement, the interest owner is required to perfect its security interest by recording a “Notice of Lien” with the county clerk of the New Mexico county in which the production unit is located.¹⁸ Failure to file a “Notice of Lien” within 45 days terminates the interest owner’s security interest.¹⁹ The “Notice of Lien” identifies, among other things, the interest owner, the well production unit number assigned by New Mexico’s Oil and Gas Accounting Commission, and the first purchaser.²⁰ If the security interest is timely perfected, the purchase money security interest and lien are afforded priority over any other lien, mortgage, or security interest that may be asserted against the oil or gas,²¹ and will continue until a buyer in the ordinary course pays the full purchase price for the oil and gas.²²

¹⁷ Specifically, “interest owners” are defined under the New Mexico statute to mean “a person owning an entire or fractional interest of any kind or nature in the products at the time they are severed from a production unit, or a person who has a right, either express or implied, to receive a monetary payment determined by the value of the products” See N.M. Stat. Ann. § 48-9-2 (West). As explained above, 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 or gas produced from their mineral interests.

¹⁸ See N.M. Stat. Ann. § 48-9-5 (West).

¹⁹ Id.

²⁰ Id.

²¹ See N.M. Stat. Ann. § 48-9-8 (West).

²² See N.M. Stat. Ann. § 48-9-3 (West).

North Dakota

Similar to New Mexico's act, North Dakota's Oil and Gas Owner's Lien Act grants interest owners²³ a continuing security interest in and lien on unpaid oil or gas until the purchase price has been paid to the interest owner. To perfect the security interest on oil and gas, producers are required to file a U.C.C.-1A in the North Dakota's central indexing system, record the lien in the real estate records in the county in which the well is located, and provide other interest owners with a copy of the notice of the lien by registered mail.²⁴ The security interest must be perfected within 90 days from the date of production, otherwise the security interest will not have priority over other security interests in the same oil or gas.²⁵ Assuming that the security interest is timely perfected, then the security interest and lien takes priority over the rights of persons whose rights or claims arise afterwards, but does not take priority over the security interest and liens previously created and perfected.²⁶

By comparison, New Mexico requires perfection within 45 days (as opposed to North Dakota's 90 days) and will create a security interest superior to other security interests (as opposed to just those created afterwards, as in North Dakota). Downstream purchasers can take comfort in knowing that in North Dakota, a buyer in the ordinary course who pays the full purchase price for the oil and gas can do so free and clear of the interest owner's lien.²⁷

Oklahoma

Prior to 2010, Oklahoma's Oil and Gas Owners' Lien Act was substantially similar to the New Mexico and North Dakota acts: interest owners had a continuing security interest in, and lien on, unpaid oil or gas until the purchase price had been paid to the interest owner.²⁸ In SemCrude, Oklahoma producers delivered over \$127 million worth of oil to SemCrude, but had not yet received payment when the company filed for bankruptcy relief.²⁹ The producers attempted to assert a priority claim over the produced oil but discovered that SemCrude had prepetition loans with secured creditors asserting a perfected lien over the same oil and gas pursuant to a contract secured by a security interest in after-acquired property.³⁰ The Delaware bankruptcy court ultimately held, among other things, that the Oklahoma producers did not have a superior

²³ The definition of "interest owners" under North Dakota's act is almost verbatim the same as the definition under New Mexico's act. See N.D. Cent. Code Ann. § 35-37-01 (West); supra note 2.

²⁴ See N.D. Cent. Code Ann. § 35-37-04 (West). After July 31, 2015, the U.C.C.-1As filed in connection with perfecting this lien must be filed electronically, as opposed to through paper copies. Id.

²⁵ Id.

²⁶ Id.

²⁷ See N.D. Cent. Code Ann. § 35-37-02 (West).

²⁸ See Okla. Stat. Ann. tit. 52, § 548.2 (West) (repealed in 2010).

²⁹ See In re SemCrude, 407 B.R. 140, 147-48 (Bankr. D. Del. 2009).

³⁰ Id.

lien because the pre-2010 Oil and Gas Owners' Lien Act expressly granted priority to U.C.C. article 9 secured parties.³¹

In 2010, in reaction to the SemCrude decision, Oklahoma revised its Oil and Gas Owners' Lien Act.³² First, Oklahoma's 2010 act removed the lien from the scope of the Uniform Commercial Code by stating that the "oil and gas lien granted by this act is granted and shall exist as part of and incident to the ownership of gas and oil rights."³³ Consequently, the "interest owner's oil and gas lien created by the Lien Act is not a [Uniform Commercial Code] Article 9 security interest but rather arises as part of a real estate interest of the interest owner in the minerals."³⁴ Under choice of law principles, the governing law for real property and security interests arising out of it is the state in which the land sits.³⁵ If perfection of the lien and security interest were governed by the Uniform Commercial Code, the law of the jurisdiction where a debtor is located would generally govern the perfection and priority of the security interest.³⁶

Interest owners in Oklahoma are granted an automatically-perfected lien without the need to file a financing statement or any other documentation.³⁷ The lien takes priority over any other lien or security interest, including those arising by contract, law, equity, or otherwise.³⁸ A downstream purchaser takes the oil and gas free of any lien only if (a) the purchaser is a buyer in the ordinary course of the first purchaser's business, and (b) the purchaser has paid all that is due to the first purchaser, including by net-out or set-off.³⁹ The lien otherwise expires one year after the last day of the month following the date that proceeds from the sale of oil or gas are due by law or contract, unless an action to enforce the lien has been commenced.⁴⁰ Although Oklahoma's act suggests that producers do not need to take action, as explained below, producers may still benefit from timely filing a U.C.C.-1 financing statement to most clearly protect their security interests from competing security interests.

³¹ Id. at 143.

³² See Sahar Jooshani, There's a New Act in Town: How the Oklahoma Oil and Gas Owners' Lien Act of 2010 Strengthens the Position of Oklahoma Interest Owners, 63 Okla. L. Rev. 133, 142 (2012).

³³ See Okla. Stat. Ann. tit. 52, § 549.3 (West).

³⁴ Id. cmt. 2.

³⁵ Id. (citing Robert A. Leflar, Luther L. McDougal, III & Robert L. Felix, AMERICAN CONFLICTS LAW §§ 165, 170 and 171 (4th ed. 1986)).

³⁶ See U.C.C. § 9-301(1) (2010).

³⁷ See Okla. Stat. Ann. tit. 52, § 549.4 (West).

³⁸ See Okla. Stat. Ann. tit. 52, § 549.7 (West).

³⁹ See Okla. Stat. Ann. tit. 52, § 549.6 (West).

⁴⁰ See Okla. Stat. Ann. tit. 52, § 549.10 (West). For example, if a contract states that payment is due on the 20th of the April, 2015, then the last day of the month following April 20, 2015 would be May 31, 2015, and one year thereon would be May 31, 2016 and the lien would expire then.

Texas and Kansas

Texas and Kansas have enacted non-uniform Uniform Commercial Codes to protect interest owners.⁴¹ Interest owners in Texas have an automatically-perfected purchase money security interest on oil and gas production and any identifiable proceeds from that production.⁴² The security interest lasts for an unlimited time if the proceeds are oil or gas inventory, accounts or chattel paper, or cash proceeds.⁴³ The interest owner's security interest and lien has priority over any purchaser who is not a buyer in the ordinary course of the first purchaser's business, but is extinguished upon the sale from the first purchaser to a buyer in the ordinary course.⁴⁴ Furthermore, the security interest and lien is treated as a purchase-money security interest for purposes of determining priority relative to other Article 9 security interests, and an interest owner that files a record evidencing a security interest will have priority over a similar interest owner whose security interest is automatically-perfected.⁴⁵

Likewise, in Kansas, interest owners are also granted a purchase money security interest on oil and gas produced to secure a first purchaser's obligation to pay for that oil or gas.⁴⁶ However, unlike in Texas, where the security interests are automatically perfected, interest owners in Kansas are required to file an "affidavit of production" in the register of deeds of the county where the oil or gas is produced to perfect their security interests on the oil and gas.⁴⁷ The affidavit of production describes any oil, gas, or mineral interest lease on a given property, the owner of the lease, and any terms or contingencies affecting the validity of the lease.⁴⁸ After perfecting the security interest, interest owners have an unlimited-duration security interest in proceeds that are oil and gas inventory, accounts or chattel paper, and cash proceeds.⁴⁹ Although the interest owner's security interest terminates when the first purchaser sells to a buyer in the ordinary course (as is the case in Texas), interest owners otherwise have priority over "bona fide purchasers," which include transferees in bulk and other buyers not in the ordinary course.⁵⁰ Consequently, bona fide purchasers may not be buying free and clear if they are not considered "buyers in the ordinary course" relative to the first purchaser. Similar to the case in Texas, the security interest in, and lien on, oil and gas is treated as a purchase-money

⁴¹ See Tex. Bus. & Com. Code Ann. § 9.343 (West); Kan. Stat. Ann. § 84-9-339a (West).

⁴² See Tex. Bus. & Com. Code Ann. § 9.343 (West).

⁴³ Id.

⁴⁴ Id.

⁴⁵ Id.

⁴⁶ See Kan. Stat. Ann. § 84-9-339a (West).

⁴⁷ Id.

⁴⁸ Id.

⁴⁹ Id.

⁵⁰ Id.

security interest for purposes of determining priority relative to other Article 9 security interests.⁵¹

Considerations for Secured Lenders and Downstream Purchasers

Given the variety of ways states handle the perfection of security interests in oil and gas, lenders to first purchasers must be prepared to face potential disputes regarding the validity and priority of their liens. If a first purchaser is financially distressed or considering commencing a bankruptcy case, both secured and unsecured creditors may attempt recovering from the same set of underlying assets. Consequently, it is advisable for lenders to take certain precautionary steps to help protect their interests in a first purchaser's collateral:

- 1) Review existing U.C.C.-1 financing statements for lingering errors, such as an inadvertent failure to file, the lapse of a financing statement, or a failure to update the financing statement.⁵²
- 2) When entering into new transactions with first purchasers, file a U.C.C.-1 financing statement in the appropriate filing office. The appropriate filing office for this type of collateral will generally be the appropriate state filing office where the debtor is organized, although this may differ for certain types of debtors.
- 3) Monitor first purchasers' operations. If a first purchaser conducts business with a producer in a state that grants producers a statutory security interest, such business may impose additional risks on a first purchaser's secured lender. To keep apprised of these risks, secured lenders could consider (a) conducting periodic searches for U.C.C.-1 financing statements filed against first purchasers or (b) requiring first purchasers to report any business operations contemplated or undertaken in a state that grants producers a statutory security interest in oil and gas.

In particular, lenders must be mindful of any actions or strategies that may ultimately worsen their positions. For example, secured lenders may attempt ordering more oil or gas from the first purchaser to setoff against amounts owed by the first purchaser. With the exception of Oklahoma, which allows for a setoff, the laws of most other states provide that a producer's lien continues unless a buyer in the ordinary course pays full consideration.⁵³ Consequently, unless the lender or downstream purchaser actually provides full consideration, ordering more gas or oil from the first purchaser and then offsetting amounts owed could prove futile. Furthermore, if

⁵¹ Id. Interestingly, the Kansas statute provides that security interests evidenced by a record will have priority over security interests automatically-perfected under the statute. However, unlike in Texas, Kansas' Uniform Commercial Code does not allow for automatic perfection, but instead requires the "affidavit of production" discussed above. The inclusion of relative priority to automatically perfected security interests is likely a scrivener's error attributed to replicating the Texas statute.

⁵² For example, if applicable, the U.C.C.-1 may have lapsed if it did not identify the debtor as a "transmitting utility," which may otherwise create a financing statement effective until a termination statement is filed. See U.C.C. § 9-515(f) (2010).

⁵³ See, e.g., N.M. Stat. Ann. § 48-9-3 (West); N.D. Cent. Code Ann. § 35-37-02 (West).

the first purchaser seeks bankruptcy protection in the near term, a downstream purchaser ordering large amounts of oil or gas may be limited in its ability to offset debts, as doing so may run afoul of sections 553 and 548 of the Bankruptcy Code – which generally prohibit offsets of debts acquired 90 days prior to a bankruptcy petition while the debtor is insolvent,⁵⁴ or which allows the trustee to avoid transfers made for less than reasonably equivalent value.⁵⁵

In light of the foregoing, secured lenders transacting with distressed first purchasers may want to consider their exposure on a gross basis as opposed to a net basis due to the possibility that pre-petition transactions, including a setoff, may be subject to challenge in a bankruptcy case.

Considerations for Producers

Unless a producer is located in a single state that allows for perfection without a financing statement and that producer also conducts business solely with parties located in that particular state, it is advisable for oil and gas producers to implement certain key practices to better protect their security interests.

Although producers in Oklahoma and Texas could theoretically rely on the automatically-perfected security interest, and producers in New Mexico and Kansas could file paperwork short of a formal U.C.C.-1 financing statement, there is a looming risk that a court finds that a perfected security interest of a debtor in a different state has priority over that producer's lien. For example, in the SemCrude bankruptcy cases, the Delaware bankruptcy court applied Delaware's choice-of-law rules regarding perfection of security interests, despite Texas producers claiming an automatically-perfected security interest under Texas state law.⁵⁶ Consequently, aside from administrative costs, there is little downside to filing a protective U.C.C.-1 financing statement. Indeed, the benefits of doing so can ultimately serve to protect an oil and gas security interest at a relatively nominal cost.

Clearly, because of the multiple parties involved with the production and shipment of any particular product, the risk arises for competing interests of lenders, producers and other creditors alike at every stage of the process. Thus, parties should beware of the intricacies of state law – lest the unwary find themselves in a much lower priority than they expected.

⁵⁴ See 11 U.S.C. § 553.

⁵⁵ See 11 U.S.C. § 548.

⁵⁶ See In re SemCrude, L.P., 407 B.R. 112, 133–34 (Bankr. D. Del. 2009).

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