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Oil and Gas Liens & Foreclosures--A Multi-State Perspective

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OIL AND GAS LIENS & FORECLOSURES — A MULTI-STATE PERSPECTIVE

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I. Introduction

This article is an attempt to provide both a general overview of issues that arise in creating, perfecting and enforcing liens on oil and gas properties and a more in-depth discussion of some of the important issues that arise in the area of oil and gas liens. Through a wide-angle lens, oil and gas lending is not very different from "hotel lending." A package of oil and gas producing properties and a chain of hotels both include significant real estate assets and virtually every category of personal property recognized by the U.C.C. All of these asset categories must be addressed in the collateral documents. However, there are issues that arise in oil and gas lending that are absolutely unique to this area. Unfortunately for any author who undertakes a

multi-state perspective on oil and gas lending or any other oil and gas topic, most of the unique issues are the product of state law idiosyncracies. For this reason, this article will be more helpful in identifying the areas where these issues arise than in providing a compendium of answers.

II. Collateral Documents¹

Oil and gas properties involve both real and personal property collateral, as defined by the law of the state in which the oil and gas properties are located.² It is beyond the scope of this article to deal with the specific documentation and recording requirements involved in creating and perfecting liens on oil and gas properties for each petroleum producing state. However, in most states a lien on oil and gas properties is treated the same as any other lien on real property. In addition, security interests in the related personal property are usually governed by the Uniform Commercial Code (UCC) as enacted in the applicable state. Each state will, however, have its own peculiarities about which local counsel will be familiar.

If the transaction involves out-of-state collateral of significant value, serious consideration should be given to retaining local counsel in the jurisdiction where the collateral is located both to assist in the preparation of collateral documents and to provide an enforceability opinion. A questionnaire for local counsel has been attached as Appendix A. This questionnaire should serve as a checklist of the issues regarding collateral documentation and enforcement that tend to vary from state to state. Local counsel's responses to the questionnaire can provide assistance in drafting and structuring the transaction, identifying whether a mortgage or deed of trust is appropriate for a given jurisdiction and specifying what steps must be taken to perfect the liens and security interests created under the mortgage against the rights of third parties. It is important, therefore, that if this or similar questionnaires are utilized, they are submitted and completed by local counsel well before the loan documents are drafted. However, the questionnaire should not be viewed or relied upon as a substitute for an enforceability opinion from local counsel.

A. Mortgage or Deed of Trust

Whether a mortgage or deed of trust should be utilized will vary from state to state. The law and custom of the state in which the properties are located will determine which instrument should be used. For referencing purposes, both will be generically referred to in this article as a "mortgage." In very general terms, the deed of trust is a three party instrument by which the borrower conveys its interest in the oil and gas properties to a third party trustee for the benefit of the lender.³ The mortgage is

1. Portions of this discussion are adapted from Terry I. Cross & Jeffrey L. Curtis, *Structuring and Documenting Oil and Gas Financing Transactions*, in COMMERCIAL FINANCE GUIDE (Joseph J. Norton et al eds., 1993).

2. See HOWARD R. WILLIAMS, ET AL., WILLIAMS & MEYERS OIL & GAS LAW § 213.5 (1996).

3. Notwithstanding the apparent conveyance accomplished by the deed of trust, in Texas and other "lien theory" states, no title or right of possession is conveyed. The deed of trust is merely a security device and creates only a lien. *Carroll v. Edmondson*, 41 S.W.2d 64 (Tex. Comm'n App. 1931).

similar to the deed of trust except that the mortgage is a two party instrument by which the borrower grants a lien directly to the lender. Each state has its own requirements regarding format, permissible terms, execution, acknowledgments, witnessing and recording. If each of the requirements is satisfied, the mortgage or deed of trust will be enforceable against the borrower and subsequent third party claimants to the property.

1. Property Description

In preparing mortgages covering oil and gas properties, the importance of the property descriptions is often overlooked. Under state law, the legal standard for sufficiency of land descriptions is usually the same for mortgages and general conveyances. A lender should recognize, however, that the property descriptions attached to the mortgage do more than simply identify the property for lien perfection purposes. If the lender must enforce its rights under the mortgage, the lender will find itself dealing with purchasers of the oil and gas production as well as potential purchasers of the properties either at a foreclosure sale or subsequently if the lender is the owner post-foreclosure. The lender's ability to direct payments to itself or to ultimately receive the maximum value for the properties, will be enhanced by complete and detailed property descriptions. The descriptions should include complete land descriptions, complete lease descriptions, well names, and the respective percentages of working and net revenue interests.

2. Multistate Transactions

Often the oil and gas properties constituting the collateral package are located in more than one state. If so, forms of collateral documents (mortgages, deeds of trust, financing statements, etc.) that are effective and can be filed in each of the applicable states can be developed. In a large multistate transaction it is usually more efficient to use a single mortgage instrument that has been modified to comply with, and obtain the optimum benefits under, laws of each of the states where the properties are located. Using different collateral documents for each state increases the burden of document preparation and review as well as the chance of conflicting or inconsistent representations, warranties or other provisions among the various collateral documents.

B. Personalty

1. Property Subject to Lien

Article 9 of the U.C.C. governs the creation, perfection, priority and enforcement of security interests in personal property. The personalty typically involved in oil and gas properties includes equipment and fixtures located on the leased premises, severed oil and gas, contracts, operating agreements, farm-out agreements, gas sales contracts, and any resulting accounts, general intangibles or proceeds.

a) Fixtures

Even though fixtures are generally regarded as realty under state law, U.C.C. section 9-313 treats the creation of a security interest in fixtures the same as security

interests in other personalty.⁴ However, what is or is not a fixture will depend on state law. In addition, the nature of equipment used in oil and gas operations is such that very little of the equipment will be fixtures. The question of whether fixtures have lost their character as personal property and become a part of the realty is determined by a three-fold test: (i) was the article annexed to the realty, (ii) was the article fit for the uses of the realty, and (iii) was it the intention of the party making the annexation that it become a permanent accession to the realty. Intent is the preeminent factor.⁵

b) Future Advances; After-Acquired Title

Future advances made while the security interest is perfected, such as those under a revolving credit facility, will have the same priority as the initial advance.⁶ Similarly, a security agreement may provide that any or all obligations covered thereby are to be secured by after-acquired collateral.⁷ Assuming the security interest has been perfected (by filing or possession, as applicable) and the secured party has given value, the security interest will attach to the after-acquired collateral at such time as the debtor has rights in the collateral.⁸

2. Formal Requisites

a) Security Agreement

Rarely, if ever, do lenders take possession of severed oil and gas. Accordingly, the "attachment" or effectiveness of a security interest in oil and gas production and other personal property is accomplished through a security agreement signed by the debtor which describes the oil and gas to be produced and a description of the land concerned.⁹ However, in most cases the mortgage covering the oil and gas properties will satisfy the U.C.C. requirements. Usually such mortgages contain a security agreement stating the borrower's intent to create a security interest in the oil and gas to be produced. Under U.C.C. section 9-203(2), the security interest then attaches when value has been given and the borrower has rights in the collateral.¹⁰

4. See U.C.C. § 9-313 (1997).

5. See *In re Tri-Sonic Inc.*, 1 B.R. 138, 146 (Bankr. N.D. Tex. 1979); *Trans-Nebraska Corp. v. Cummings Inc.*, 595 S.W.2d 922, 923 (Tex. Civ. App. 1980, no writ); *Fenlon v. Jaffee*, 553 S.W.2d 422, 428 (Tex. Civ. App. 1977, writ ref'd n.r.e.). There are very few fixtures in the oil patch. Even in the absence of a specific expression of intent, Texas courts have generally held that equipment used on oil and gas leases, including down-hole equipment such as casing, are not fixtures. For cases specifically dealing with casing, see *Wagner Supply Co. v. Bateman*, 18 S.W.2d 1052, 1053 (Tex. 1929) and *Crabb v. The Keystone Pipe & Supply Co.*, 177 S.W.2d 989, 990 (Tex. Civ. App. 1944, writ ref'd.).

6. See U.C.C. § 9-312(7) (1997).

7. See U.C.C. § 9-204 (1997).

8. See U.C.C. § 9-203 (1997).

9. See *id.*

10. See U.C.C. § 9-203(2) (1997).

b) Financing Statement

To perfect by filing a financing statement covering oil and gas to be produced, the financing statement must adhere to the formal requirements of the U.C.C. as enacted in the applicable state. Most states require the financing statement to recite that it is to be filed for record in the real estate records and to contain a description of the real estate sufficient for recordation purposes.¹¹ If the borrower does not have an interest of record in the real estate, the financing statement must show the name of the record owner.¹² The collateral instrument itself (whether a mortgage, deed of trust, security agreement, etc.) can also constitute, and be filed as, a financing statement if it satisfies the requirements.¹³ See below for a more detailed look at perfection of security interests in personalty.

C. Assignment of Production

1. Virtual Realty or Just Another Security Interest?

An assignment of production provision is a common feature of oil and gas mortgages. A typical assignment of production provision is attached as Appendix B. Even though some assignment of production provisions, if read by themselves, appear to be unconditional assignments of the right to production proceeds, they are collateral devices and do not approach "true sale" status.¹⁴

While oil and gas interests are either realty or treated like realty in most states, severed oil and gas production and the resulting proceeds are personal property and the perfection of security interests in these items of collateral are governed by U.C.C. sections 9-401(1)(a) and 9-402(1), (2), (5) and (6). Despite the clear language of U.C.C. sections 9-401 and 9-402 regarding severed oil and gas and the proceeds thereof, state law rules limiting pre-foreclosure remedies under real estate mortgages have created some concerns regarding the effect and enforceability of assignments of production. The combination of pre-Code cases treating assignments of production as essentially creating real property rights¹⁵ and post-Code cases holding that an assignment of rents from real estate takes effect only after default and the lender takes action to enforce its remedies¹⁶ creates some lingering uncertainty about whether these restrictions that pertain to real estate limit the assignment of production. In an Oklahoma case, *FDIC v. Hulsey*,¹⁷ the combination of the "virtual realty" mindset and a statute¹⁸ providing that assignments of production effective upon future default were

11. See U.C.C. § 9-401(a) (1997).

12. See U.C.C. § 9-402(5) (1997).

13. See U.C.C. § 9-402 (1997).

14. For a discussion of asset securitization in the oil and gas finance area, including the requisites to constitute a "true sale" of accounts receivable arising from oil and gas sales, see generally Charles E. Harrell, et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885 (1997).

15. See *Continental Supply Co. v. Marshall*, 152 F.2d 300, 306 (10th Cir. 1945).

16. See *In re Village Properties, Ltd.*, 723 F.2d 441, 444 (5th Cir. 1984); *Taylor v. Brennan*, 621 S.W.2d 592, 593-94 (Tex. 1981).

17. 22 F.3d 1472, 1484-85 (10th Cir. 1994).

18. See 46 OKLA. STAT. § 4 (1991). This statute was amended in 1986 expressly to authorize

invalid was the basis for an attack on the applicability of the U.C.C. to an assignment of production. The *Hulsey* opinion analyzes some pre-Code cases that held that because oil and gas proceeds "affect and relate to real estate," real property law should apply to the assignment of production clause.¹⁹ Ultimately, the court in *Hulsey* recognized the severance of oil and gas as a clear demarcation line for the applicability of the U.C.C. rather than as some metaphysical mystery that precludes applying the U.C.C.²⁰

Because minerals (and crops and timber for that matter) are personalty when produced, and in view of the manner in which sections 9-401(a)(2) and 9-402(c) and (f) treat these items, section 9-502(a) should entitle the lender to treat the proceeds of production as just another account receivable "when so agreed and in any event upon default."²¹ The 1994 Revised Report of the ABA U.C.C. Committee Task Force on Oil and Gas Finance²² has proposed revisions to article 9 intended to underscore the effectiveness of the Code to oil and gas from the moment of production.

2. Structure Issues

a) Direct Payments to Lender

Different approaches can be taken in assignments of production. The borrower and lender need to consider the practicality of each approach before deciding which is the most appropriate. After assessing the credit risks involved in some oil and gas loans, the lender may require that all production proceeds be paid directly to the lender rather than to the borrower. Accordingly, the borrower will be required to sign and deliver to the lender transfer orders or their equivalent addressed to the purchaser of production or the disbursing agent of production proceeds. After the transfer orders are sent to and received by such parties, future proceeds of production will be paid directly to the lender for the borrower's account. The lender is then able to apply immediately to the loan the proceeds received without running the risk of some intervening creditor obtaining such funds.

b) Direct Payments to Borrower for Benefit of Lender

In some cases the lender will forego receiving the direct payment of production proceeds, particularly in instances where gross proceeds of production are paid to the borrower and the lender is comfortable with the borrower's overall creditworthiness. In addition, many lenders are reluctant to assume the administrative burden and risk of receiving gross revenues directly from the purchaser of production. Receiving gross revenues can render a lender liable for the payment of operating expenses under

assignments of production effective upon default.

19. *Id.* at 1483.

20. *See id.* at 1484; *see also In re Arithson*, 175 B.R. 313, 323 (Bankr. N.D. 1994) (analyzing the pre-production and post-production dichotomy).

21. U.C.C. § 9-502(a)(1) (1997).

22. Alvin C. Harrell & Owen L. Anderson, *Report of the ABA UCC Committee Task Force on Oil and Gas Finance*, 25 TEX. TECH L. REV. 805, 807 (1994).

quantum meruit or other equitable principles.²³ The borrower and lender should devise a mechanism to cause the borrower's operating expenses to be paid from the production proceeds. In addition, gross payments from the purchaser of production usually include proceeds allocable to interest owners other than the borrower. Therefore, if the borrower is the operator of any properties, the lender could find itself involved in disbursing proceeds to some or all of the nonoperator working interest owners. Even if the borrower is not the operator, the gross payment may include funds payable to royalty owners. In any event, the liability for inadvertently misapplying the funds together with the inconvenience and cost of performing the related accounting functions are likely to outweigh the credit risks of permitting the borrower to receive the payments directly.

Even if the lender forgoes direct payment of production runs, the lender will still require the execution and delivery at closing of transfer orders. In this way the transfer orders are "on hand" if a default occurs and it becomes necessary for the lender to start receiving the payments directly. Even if a borrower's financial condition is rapidly declining and a default occurs, from a practical standpoint, the borrower should not receive more than one month of production proceeds before the lender causes a transfer order to become operable.

c) Collateral Account or Lockbox

Rather than relying on transfer orders, some lenders require the implementation of a controlled collateral account. Under this procedure, disbursers of production proceeds are notified to send "run checks" or the proceeds of production directly to a post office box or lockbox under the control of the lender. The handling of checks and other items delivered into the post office box or lockbox is usually spelled out in the loan agreement or a separate lockbox agreement. The controlled account provision or lockbox agreement will authorize the lender to open mail delivered to the post office box or lockbox and deposit checks received into a controlled account of the borrower at the lender/bank. In some cases the lender is further authorized to apply an appropriate amount of the payments received to principal and interest on a periodic basis and transfer the remainder to an operating account of the borrower. Appendix C below contains an example of provisions establishing a controlled post office box and collateral account into which production proceeds are deposited.

The advantage of using a collateral account is that the lender avoids the complications involved in delivering transfer orders prior to a loan default and the burden of accounting for gross revenues. The lender has the added benefit of being able to monitor the cash flow from the collateral properties. In addition, by having possession and control over the controlled account, the lender is in the best possible position to offset funds against the debt if it becomes necessary.

23. See *Pioneer Operations Co. v. Brandeberry*, 789 P.2d 1182, 1187-88 (Kan. Ct. App. 1990).

III. Perfection and Priority of Collateral Liens

A. Real Property — In General

As mentioned in the discussion above, the standard collateral instrument used to create liens and security interests in oil and gas properties is either the mortgage or the deed of trust; the law of the state in which the property is located will determine which should be used. However, to be enforceable against and have priority over the competing claims of third parties (subsequent purchasers and lienholders), the mortgage or deed of trust must be recorded in accordance with the recording statutes of the applicable state as soon as possible following execution. If lender's counsel is unfamiliar with the law of the state in which the oil and gas properties are located, it is usually advisable to obtain the advice and assistance of local counsel to ensure the mortgage or deed of trust is promptly and properly recorded. Only then will the lender's lien and security interest be perfected, the filed mortgage or deed of trust putting third parties on notice of the lender's interest. Thereafter, third parties acquiring an interest in the mortgaged properties do so subject to the rights of the lender. The local counsel questionnaire, Appendix A below, provides assistance in document preparation and identifying the recording requirements, and provides enforcement rules for each state concerned.

B. Personal Property — In General

1. Perfection

As mentioned earlier, the personal property comprising the collateral in connection with oil and gas properties will usually consist of oil field equipment and fixtures located on leases, oil and gas production, contracts and agreements, and resulting accounts and proceeds.

The perfection of a security interest in these types of collateral will depend on how they are classified under article 9 of the U.C.C. for the applicable state. In addition, the applicable U.C.C. provisions will specify the rules by which the lender's security interest is to be perfected. In general, however, to perfect a security interest in oil and gas produced and any related accounts or fixtures (and collateral which is intended to become fixtures), a financing statement complying with U.C.C. section 9-402 (in particular U.C.C. section 9-402(5)) should be filed in the appropriate recording office.²⁴ In most cases, the mortgage, if properly prepared and when properly recorded, will satisfy the local filing requirements under U.C.C. section 9-401(2).²⁵ Perfection of all other personal property collateral will require filing a financing statement centrally with the applicable secretary of state or other designated state office.²⁶

24. See U.C.C. § 9-401(1) (1997).

25. See *id.* § 9-402(6).

26. See *id.* § 9-401(1)(b).

A financing statement lapses five years from the date of filing. However, the lender can continue the effectiveness of the financing statement and maintain perfection by filing a continuation statement within six months prior to the end of the five-year period.²⁷ The debtor need not execute the continuation statement in order for it to be effective.²⁸

Obviously, local law must be examined to confirm the filing and perfection requirements in each jurisdiction in which collateral is located. The local counsel questionnaire touches on the subject, but the assistance of local counsel in assuring that all conditions to filing and perfection have been satisfied is probably warranted depending on the value of the properties.

2. Priorities

U.C.C. section 9-312 sets forth the rules regarding priorities among conflicting security interests in the same collateral. The general rule is that conflicting security interests rank according to priority in time of filing or perfection.²⁹ If all competing security interests are unperfected, the first of them to attach has priority.³⁰ The only notable exception to these general priority rules relates to "inventory." Oil and gas, and their related products, become inventory when produced and in the hands of producers, pipelines, production purchasers and refiners. Ordinarily, any existing liens would continue in the oil and gas, notwithstanding any subsequent sale or disposition without the lender's consent.³¹ However, if that inventory is sold by the borrower in the ordinary course of business, the purchaser acquires the inventory free and clear of any security interest. Therefore, oil and gas producers, pipelines, purchasers, and refiners selling production in the ordinary conduct of their business do so freely and clearly of any lien created in favor of the lender under U.C.C. section 9-307(a). The same rule would also apply to sales of used oilfield equipment by used equipment dealers. Purchasers would acquire such equipment free and clear of any liens.

C. Onshore Federal and Indian Leases

There are three critical issues for the lender who expects to acquire a lien in oil and gas leases covering minerals owned by the United States or by Indian tribes. The first issue is whether a title search is necessary, or even possible, to verify the borrower's ownership interest in the leases and whether such interests are unencumbered. The second issue concerns the manner in which the lender perfects its lien against the claims of persons who may subsequently claim ownership interests or liens by, through, or under the borrower. The third issue is identifying the circumstances under which the United States or the pertinent Indian tribe will recognize the lender or any other foreclosure sale purchaser as the new owner of the borrower's interest.

27. *See id.* § 9-403(3).

28. *See id.* § 9-402(6).

29. *See id.* § 9-312(5)(a).

30. *See id.* § 9-312(5)(b).

31. *See id.* §§ 9-206(1), 9-312.

1. Federal Records vs. County Records

The borrower's rights as a lessee under federal and Indian leases are governed by applicable federal statutes and regulations and to some extent by tribal ordinances and other actions. However, applicable state law will determine whether persons claiming rights in the oil and gas properties through the borrower (including the lender) will have the benefits accorded a "bona fide purchaser" under the recording act of that state. In addition, most states having federal or Indian lands within their borders have developed a body of case law on the subject of whether filings in the Bureau of Land Management, Mineral Management Service (MMS) records will afford notice to purchasers or creditors of owners in federal or Indian leases.

New Mexico and Wyoming courts have held that filing in the MMS records is insufficient by itself to prevent subsequent purchasers from becoming bona fide purchasers under these states' respective recording acts.³² Under Colorado law, filings with the MMS will provide inquiry/constructive notice to persons dealing with owners of federal leases.³³ A lender contemplating making a loan secured by federal or Indian oil and gas leases should search both the county records and the records maintained by the MMS and file its mortgage in both places.

2. Perfection of Lien

The Minerals Lands Leasing Act of 1920³⁴ and the federal regulations promulgated under the act do not authorize or otherwise provide for the filing of mortgage documents with the MMS or any other bureau or agency within the Department of the Interior. In the absence of any such authorization, the presence of a mortgage in such records is probably of little legal consequence. Nevertheless, a lender should consider delivering a "notice of encumbrance" to the MMS office for the state where the collateral lease is located, together with a copy of the mortgage for filing. Some MMS offices will accept both the notice and the mortgage for filing, some will only accept the notice, while others will accept neither. These filings may have no effect against the MMS. However, the presence of the filings in the MMS records will provide actual notice to third persons dealing with the borrower and others who actually inspect the records.

As mentioned above, filing the notice and/or mortgage with the MMS does not relieve the lender of filing the mortgage in the county records where the land is located. Filing in the appropriate county and complying with the applicable recording act is the only method by which the lender can be assured its rights are perfected against the rights of subsequent purchasers and creditors.

32. See *Bolack v. Underwood*, 340 F.2d 816, 819 (10th Cir. 1965) (construing New Mexico law); *Dame v. Mileski*, 340 P.2d 205, 207 (Wyo. 1959) (construing Wyoming law).

33. See *Page v. Fees-Krey, Inc.*, 617 P.2d 1188, 1198 (Colo. 1980).

34. 30 U.S.C. §§ 181-287 (1994).

3. Post-Foreclosure

The party who acquires an interest in a federal or Indian lease at a foreclosure sale will ultimately need to have the Department of the Interior (and Indian tribe if applicable) recognize that party as the owner. The assignment of a federal lease or an Indian lease, including the transfer effectuated by a foreclosure sale, must be approved by the Office of the Secretary of the Interior in order to be binding on the lessor.³⁵ These regulations establish certain qualifications for a potential owner of an oil and gas lease, including a bonding requirement.³⁶

D. Outer Continental Shelf (OCS)

The same issues regarding the appropriate repositories for filings in connection with federal or Indian lands are also pertinent to leases on the OCS. Resolution of these issues is complicated by the fact that, technically speaking, OCS leases are not located in any county or state.

A portion of the Outer Continental Shelf Lands Act³⁷ provides that regarding which law governs on the OCS, state law will apply to the extent applicable and to the extent the subject matter is not already covered by federal law. Which state's law is applicable is determined by extending the boundaries of each state seaward to the outer margin of the OCS. The law of the adjacent state will govern. In determining how courts might deal with mortgage perfection issues, some recent decisions dealing with the applicability of the mineral contractors' lien statutes are instructive.

In *Genina Marine Services, Inc. v. ARCO Oil & Gas Co.*,³⁸ the court held that the Louisiana contractors' lien statute was applicable to the OCS because Louisiana's lien statute was not inconsistent with federal law and the wells would be within the area of the State of Louisiana if its boundaries were extended seaward as provided in the Outer Continental Shelf Lands Act.³⁹

The Fifth Circuit, in *Union Texas Petroleum Corp. v. PLT Engineering, Inc.*,⁴⁰ held that a Louisiana mineral contractor's lien in an OCS lease is properly perfected, and its priority established, by filing in the records of the adjacent parish.⁴¹ The court's reasoning with regard to a state lien statute would seem just as applicable to mortgage perfection issues:

If [the Louisiana contractors' lien statute] were to be read as [appellant] urges, to allow liens to be recorded only if the property is located on *land* in a parish, it would deny the subcontractors the protection of Louisiana

35. See *id.* § 187; see also 43 C.F.R. § 3000.0 through 3000.9 (1997) (regarding federal leases); 25 C.F.R. § 211.26 (1997) (regarding Indian leases).

36. See Robert A. Bassett, *The Insecurity of Mortgages on Federal Mineral Leases*, 18 COLO. LAW. 447, 447 (1989).

37. 43 U.S.C. § 1333 (1994).

38. 499 So. 2d 257 (La. Ct. App. 1986).

39. See *id.* at 260.

40. 895 F.2d 1043 (5th Cir. 1990).

41. See *id.* at 1047.

law merely because their work was performed on the OCS rather than on shore. At the least, this would frustrate the Congressional intent behind OCSLA that state law operate as surrogate federal law on the OCS. It would be anomalous to deny the liens here when a principal reason for adopting state law to apply as federal law on the OCS was to protect all those who perform activities including providing services and materials on the OCS. (citations omitted).⁴²

Finally, in *World Hospitality, Ltd v. Shell Offshore, Inc.*,⁴³ a federal district court held that (1) the Texas statutory contractors' lien extended to the OCS, and (2) the filing of a statutory lien claim with the MMS was of no consequence (i.e., the records of adjacent counties were appropriate).⁴⁴

IV. Representations and Warranties

One important aspect of the typical oil and gas loan is the representations and warranties required by the lender. While some representations and warranties are customary, others will be heavily negotiated.

A. Purpose

The function of representations and warranties is to obtain from the borrower written confirmation regarding the truthfulness and accuracy of certain basic assumptions the lender has made or will make in connection with the loan and the collateral. Although representations and warranties have an important role in any credit relationship, they are no substitute for independent verification of any assumptions that are crucial to the credit decision, nor are they a substitute for a legal opinion from borrower's counsel.

In addition to "standard" representations which are relevant in all loans (e.g., representations as to the borrower's valid existence and authority to borrow money), the loan agreement and collateral documents for an oil and gas production loan should include representations and warranties which focus on the borrower's ownership and development of the oil and gas properties, the applicable reserves and the borrower's corresponding right to extract production.

Representations and warranties often become a battleground between the borrower and lender. The standard approach taken by lender's counsel is to draft representations broadly to force the borrower to provide a complete picture of its business and financial condition and to smoke out problems (e.g., "there are no actions, suits or legal, equitable, arbitration or administrative proceedings pending or threatened against borrower . . ."). Depending on the lender's familiarity with the borrower, the lender will usually modify the proposed representations by including specific exceptions or by narrowing the scope to address more directly the lender's concern. Borrowers with large and complex businesses may also be successful in qualifying their represen-

42. *Id.* at 1051 (emphasis added).

43. 699 F. Supp. 111 (S.D. Tex. 1988).

44. *See id.* at 113.

tations by a materiality standard (e.g., "there are no *material* actions, suits . . ."). However, as a general rule lenders resist attempts by borrowers to limit representations to the "borrower's knowledge," because whether the borrower *knows* of an inaccuracy is not the issue. An inaccurate representation can change a basic understanding upon which the loan was made and, if material, permit the lender to terminate both the lender's obligation to make future advances and the lending relationship.

Under some circumstances, it may be appropriate for the lender to obtain representations as to the business or financial condition of a nonborrowing party (such as a subsidiary or guarantor). Lenders should also ensure that all significant parties to the credit transaction are covered by representations either in the loan agreement or in the collateral documents. In addition, the terms of a revolving credit facility should require the borrower to remake certain representations as a condition to obtaining advances during the revolving period.

B. Selected Considerations

The lending lawyer must make a decision regarding which representations and warranties will appear in the collateral documents and in the credit agreement. While many representations and warranties can legitimately appear either place, the better practice is not to duplicate any. Certainly, if the same subject is covered twice, the exact language should be used each time. Generally, the representations and warranties directed solely at the collateral will appear in the collateral documents. Specific representations regarding the oil and gas properties to be mortgaged should be obtained, including the following:

(1) Borrower has good title to the quantity of interest evaluated by the lender in the reserve report, and the collateral documents constitute a first priority lien, subject only to specific permitted encumbrances (e.g., operator's lien).

(2) Borrower's marketing arrangements are valid, enforceable and in full force and effect. In addition, the existence and extent of cumulative imbalances in gas production and receipt of "take or pay" payments have been disclosed.

(3) All bills and taxes have been paid.

(4) Leases are in full force and effect and borrower is in compliance with its obligations under the leases.

(5) All wells are drilled and produced in compliance with applicable regulations (e.g., no deviated holes or production beyond the allowable).

(6) There are no environmental problems.

(7) There are no outstanding A.F.E.s and the borrower has not elected to go "nonconsent" on any operations.

V. Covenants

A. Purpose

The purpose of covenants in a loan agreement is to require the borrower to take certain actions (affirmative covenants), or refrain from taking others (negative covenants), so as to improve or maintain the borrower's financial position and the quality of the collateral, thereby enhancing the collectibility of the loan. If the

borrower violates a covenant during the term of the loan, the lender can then declare a default, accelerate maturity of the loan and terminate the lending commitment. More importantly though, the borrower's covenants are not intended solely to promote financial stability and collateral quality. They are also intended to maintain the lender's pre-eminent status between itself and the borrower's other creditors should there be a competition for the borrower's assets in a bankruptcy or insolvency.

Covenants may be grouped into six functional categories:

- (1) those requiring the borrower to conform to good business practices;
- (2) those requiring the borrower to deliver financial information;
- (3) those prohibiting the borrower from so fundamentally changing its business structure or manner of doing business as to render more specific provisions invalid or to undermine the premises upon which the lender's initial credit decision was made;
- (4) those maintaining the borrower's financial condition and the lender's status and priority with respect to the borrower's other creditors;
- (5) those requiring continued maintenance of collateral protection; and
- (6) those imposing special requirements based on the nature of collateral security.

Of the six covenant categories, the first four are usually contained in the loan agreement and the latter two in the collateral documents.

Much of the negotiation involved in the oil and gas production loan will be focused on the covenants because of the restrictive effect they have on the borrower's business activities. The borrower will usually seek exceptions to covenants, some of which are "standard" and others of which reflect the special business needs of the borrower. In addition, the borrower will usually request grace periods within which the borrower can cure covenant violations without triggering an "event of default" and the lender's enforcement remedies. The lender is usually willing to consider grace periods for covenant breaches caused by the actions of third parties (e.g., imposition of inchoate or mechanic's liens or involuntary bankruptcies). The lender is less willing, however, to grant grace periods for covenant defaults resulting from the intentional act of the borrower (e.g., the borrower's grant of subsequent liens, sales or dispositions of collateral, failure to observe financial covenants, etc.). Therefore, drafting of the covenants requires that the lender (and to a lesser extent, the lender's lawyer) understand the borrower's business and the true credit assumptions upon which the loan is based.

A borrower will want to avoid "open-ended" covenants (e.g., "borrower will do such other things *as lender may from time to time require*") and covenants based on "subjective" standards (e.g., "borrower will at all times maintain management personnel *satisfactory to lender*"). The borrower frequently will negotiate for flexible adjective qualifiers such as "reasonable," "material," "substantial," etc. (e.g., "borrower will not prepay any *material* third-party debt" or "borrower will not sell a *substantial* portion of its assets"). Note that these adjectives are not easily defined and, therefore, may later prevent the lender from declaring a default based on violations of the covenant.

B. Special Considerations

Because of the issues related to the oil and gas collateral, certain covenants are especially needed by a lender making an oil and gas loan. These covenants will address the lender's two primary concerns of preservation of collateral and obtaining sufficient information regarding production from the oil and gas reserves. For example, it is common in an oil and gas production loan to find covenants which require the borrower to:

- (1) deliver production information on a monthly basis;
- (2) deliver all operating agreements, pooling or unitization agreements, sales or processing contracts, drilling and/or development agreements, pipeline transportation agreements and other material agreements which pertain to the oil and gas properties;
- (3) deliver copies of all reports, forms and other documents and data submitted by the borrower to certain governmental agencies such as the applicable state conservation agency, Federal Energy Regulatory Commission, etc.;
- (4) act prudently and in accordance with customary industry standards in managing or operating the oil and gas properties;
- (5) pay and promptly discharge all rentals, delay rentals, royalties, overriding royalties, payments of production and other indebtedness or obligations accruing under the leases covering the oil and gas properties, and perform every act required to keep such leases in full force and effect;
- (6) explore, develop and maintain the leases, wells, units and acreage to which the oil and gas properties pertain in a prudent and economical manner;
- (7) perform all acts and execute such documents as the lender may require in order to maintain the lender's lien on the oil and gas properties;
- (8) not mortgage, pledge or otherwise encumber the oil and gas properties;
- (9) not sell the oil and gas properties; and
- (10) not alter any material agreement relating to the oil and gas properties.

VI. Due Diligence and Title Verification

The purpose of a "due diligence" review, including title verification, is to confirm that the assumptions in the reserve report and the lender's resulting loan valuation are accurate. However, designing the lender's due diligence review will require balancing the need for information regarding the oil and gas properties involved against the time and expense of an exhaustive investigation. Decisions regarding the scope and extent of the investigation must be made jointly by the lender and lender's counsel. Of course, since the borrower typically pays the lender's attorneys fees, the borrower's expectations must also be considered. In addition, when designating a due diligence strategy, both lender and its counsel must understand and remain focused on the lender's objectives and the bases upon which the lender computed the loan value of the properties. Accordingly, the strategy may be to identify the relative values of the properties to be mortgaged and conduct the review on those properties with the most value.

A. Title Opinions

In most oil and gas producing states, title insurance is unavailable for mineral properties. Accordingly, whenever mineral interests are bought, wells are drilled or someone is called upon to take a risk in regard to the properties, title opinions prepared by attorneys are usually obtained. To assist in the preparation of title opinions for the production loan, the borrower will usually have already obtained title opinions rendered prior to the time the corresponding wells were drilled. In addition, after production was established, the borrower should have obtained division order title opinions setting forth how the production proceeds should be paid. There may also be other title opinions rendered in connection with previous transfers of the properties or prior financing transactions. Assuming these opinions were rendered by attorneys of good reputation, the lender will usually allow the borrower merely to update the most recent opinions. If the borrower is a nonoperating working interest owner and does not have any title opinions, copies are usually available from the operator since the nonoperator has probably paid for its pro-rata share of the title opinions under the provisions of the applicable operating agreement.

As mentioned above, decisions regarding the procedures to be used to verify record title, like all other due diligence decisions, will require a cost benefit analysis. Lender and lender's counsel must balance the strong desire to avoid title related losses against the time and expense of a thorough title examination of every property in the collateral package. The safest practice is to have title opinions rendered based on title examinations ending shortly before the closing date of the loan. Then, on the date of the closing, a search of the records is conducted and the deed of trust filed for record prior to funding.

If the time and expense of title examinations on every property cannot be justified, several options are available: the least valuable properties can be excluded, nonlawyers can be used for mere "record checks," or the examinations themselves can be limited in scope (e.g., searching the record for only lien filings and conveyances by the borrower). Alternatively, the lender may choose to rely on recent title opinions, if available, that confirm (as of their effective dates) that the borrower has good title to the interests in the oil and gas properties evaluated. If such a procedure is followed, however, the lender must require that a search of the deed records is conducted contemporaneously with the closing of the lending transaction to obtain optimum title protection.

There are a number of factors that, if present with respect to one or more properties, weigh strongly in favor of conducting a title examination. Such factors include the following:

Who is the borrower? Certain participants in the oil and gas industry are more likely to create title problems than are others. Promoters are more likely to structure complicated and creative transactions and convey out multiple interests. Thinly capitalized companies are more likely to create liens or encumbrances on their interests. If the borrower is a promoter or has at times been thinly capitalized, or such a party has been in the chain of title to the property since the last title opinions, current title examination may be needed.

Value of the properties/diversification of risk. If the collateral consists of a relatively small group of extremely valuable properties or if a disproportionate amount of the collateral value is concentrated in a small group of properties, the benefits from a thorough title examination are obvious.

How long has any given property been producing? There is often a flurry of conveyancing activity immediately before and after a well is drilled. In addition, if the bills for drilling or for a major workover of the well are not paid, statutory contractor's lien filings usually follow shortly after completion of the operations. If wells have been drilled or major operations conducted since the last available title opinions, updated title opinions may be in order.

How old are the existing opinions? While most title problems are flushed out by the completion of a producing well and the preparation of the division order title opinion, this is not always the case. Existing title opinions may be old or the properties may have been conveyed several times since the prior opinions. If the existing opinions are stale, or there have been repeated conveyances, title examination may be advisable.

How many counties or parishes are involved? If significant value is concentrated in a small number of counties or parishes, the incremental cost of examining the title to properties of both lesser and greater value in the same county is not great.

The purpose of the title examination is to confirm that: (1) the borrower owns the interest represented by the borrower and evaluated in the reserve report, and (2) the borrower's interest is unencumbered. In conducting the title search, the title examiner will review all records maintained by the county or parish clerk, including, without limitation, mechanic's lien records, abstract of judgment records, federal tax lien records, lis pendens records, deed of trust records and deed records, and any miscellaneous indices maintained in the subject county. Although court proceedings which affect real property should be evidenced by filings in the same location, court records should be searched anyway. In addition, the lender should verify through the title examiner that all ad valorem taxes are paid. In most jurisdictions, the lien of taxing authorities to secure ad valorem taxes will be superior to any contractual liens without regard to the inception dates of the respective liens and without any filing in the county records by the taxing authority.⁴⁵

B. File Review

A cautious lender will not only obtain updated title opinions, but will also conduct a thorough review of the borrower's files. The purpose of the file review is to "close the loop" between the title examination and the reserve report. The file review will generally cover a list of issues that parallels the representations and warranties contained in the loan agreement and the collateral documents. All of the borrower's files which deal with the properties should be reviewed, including the document files and correspondence files. Correspondence files are especially important because they may contain demand letters, inquiry letters, and internal memoranda that raise issues

45. See, e.g., TEX. TAX CODE ANN. § 32.05(b), 113.001-113.011 (West 1997).

regarding lease perpetuation, gas balancing, damage claims, environmental liabilities and other matters directly or indirectly bearing on the value of the collateral.

1. Confirming Assumptions in the Reserve Report

The lender must not only verify that the borrower owns the subject properties, but also that the properties evaluated in the reserve report are the ones described in the deed of trust and covered by the title opinions. Further, the lender should confirm the assumptions made by the petroleum engineer in the reserve report. Areas where the engineer has, or may have, made assumptions include pricing, expenses and title.

a) Pricing

Of course, predictions regarding the future market price of oil or gas are speculative and not subject to confirmation. However, if the reserve report assumes prices higher than prevailing market prices, due diligence must confirm that the borrower has existing contracts which justify the collection of the higher prices. If the reserve report assumes that market prices will be paid, due diligence should confirm that existing contracts are payable at market prices.

b) Expenses

The evaluating engineer must make certain assumptions regarding operating expenses. Typically, these amounts are supplied by the borrower. While legal counsel is not generally responsible for verifying the borrower's operating expenses or other accounting matters, counsel should be aware of the source of the engineer's information and confirm that accounting due diligence is being conducted to verify the engineer's assumptions in this regard. The failure of the engineer to incorporate any expenses, such as the cost of salt water disposal, will distort the conclusions regarding value. Also, the failure to incorporate compression, transportation or treating charges in the pricing assumptions will yield an inflated value for the properties.

c) Title

The evaluating engineer assumes that the seller has good title to the interests that are evaluated. It is critical for the lender to understand what interests have in fact been evaluated in determining the collateral value.

Working interest. The lender should confirm that the borrower bears only the assumed working interest percentage of expenses in order to recover the evaluated reserves. A contractual obligation to "carry" another party by paying all or a portion of that party's expenses would diminish the value of the interest, but would not necessarily be taken into account by the reserve engineer.

Net revenue interest. The lender should also confirm that the borrower is entitled to retain the proceeds of production in the percentage indicated by the reserve report as borrower's "net revenue interest." Examples of circumstances which the evaluating engineer may have failed to take into account include:

(1) *Nonconsent Elections.* If the borrower has elected to "go nonconsent" on any proposed operations, there is a relinquishment of the borrower's interest in the subject

well during the nonconsent penalty period under the provisions of the applicable operating agreement; or

(2) *Take or Pay/Gas Balancing/Production Beyond Allowable*. Typically, the reserve engineer makes computations regarding the reserves in place and allocates those reserves to the borrower's assumed net revenue interest. The engineer may overvalue the borrower's interest if the engineer fails to consider and take into account whether:

(a) the borrower is obligated to deliver gas in the future without receiving payment because of "take or pay" payments received in the past,

(b) the borrower has "overproduced" and underproduced parties have the right to take more than their proportionate share of the wellstream in the future during which time the borrower must take less than its proportionate share of the wellstream, or

(c) the production from a well will be restricted in the future because of past production in excess of the well's allowable.

2. *Confirming Land and Depths*

The borrower must own the depths evaluated in the reserve report, and the wells listed in the report must be located on the land and completed in the depths owned by the borrower. "Closing the loop" regarding land descriptions can be complicated somewhat if the reserve report uses only well names and does not include land descriptions. Even if the reserve report includes land descriptions, a cautious lender will review drilling permits and completion reports from state conservation agencies to verify that the evaluated wells are located on the land and leases, completed at the depths, described in the mortgage, and covered by the title opinions. If the reserve report evaluates, and the lender gives value to, proved nonproducing reserves, the lender must confirm that the borrower actually owns leases which cover and will continue to cover such nonproducing reserves. The lender and lender's counsel should review leases for the existence of Pugh clauses and "retained acreage clauses." Such clauses can result in leases which, although originally covering areas, ultimately cover only the land and depths within producing units.

3. *Confirming the Effect of After Payout Reversions*

Usually, the reserve engineer will take into account "after payout reversions." Occasionally, however, the reserve engineer will receive inaccurate information regarding when these reversions will occur. If the engineer assumes that the reversion will occur significantly earlier or later than it actually does, the value of the subject property could be materially overestimated or underestimated. While the payout status of a well is basically an accounting issue, counsel should confirm that the reserve engineer used accurate information and that there is no latent dispute regarding payout status. If the status of payout of a well is critical, an estoppel letter from the parties who will suffer or benefit from the reversion may be appropriate.

VII. *Competing Liens*

The title search may reveal competing contractual or statutory liens. If so, a release or subordination of those liens must be obtained prior to the lender advancing funds

if the lender is to have a first priority lien. The operator's lien created by standard-form operating agreements, and the statutory mineral contractor's lien provided to contractors in many states, are discussed specifically below.

A. *The Operator's Lien*

The lien provisions contained in the American Association of Petroleum Landmen's (AAPL) Model Form (1977, 1982 and 1989) Operating Agreement are sufficient to grant a lien in real property and will satisfy the requirements of U.C.C. article 9 for a security agreement if the operating agreement is properly executed and the Exhibit A included with the form is completed. If a recital that the model form is to be filed in the real estate records is added, the model form operating agreement will also then satisfy the corresponding requirement of U.C.C. section 9-402(e) for financing statements covering minerals. The model forms do not, however, include an acknowledgment. Accordingly, in order to record the operating agreement in the real estate records of most jurisdictions, an acknowledgment must be added to the instrument contemporaneously with its execution.

While the operating agreement often is not recorded, producers are recording memoranda of operating agreements (containing the lien provisions and executed by all parties) with increasing frequency. In some states, a reference to an unrecorded operating agreement in the chain of title will afford notice of the operator's lien. In such "notice" states, the unrecorded operator's lien then becomes superior to even a subsequent, recorded deed of trust lien.⁴⁶ However, in a pure "race" jurisdiction like Louisiana, unrecorded operator's liens will lose to recorded liens without regard to the recorded lienholder's notice or actual knowledge.⁴⁷ In "notice" jurisdictions, the operator may be able to argue successfully that it is in "possession" of the leases and all persons dealing with realty are on notice of the rights of parties in possession.⁴⁸ The operator may also have a perfected security interest in the equipment and severed oil and gas on the lease premises by reason of having possession of such goods.⁴⁹ Most borrowers insist on making the mortgage expressly subject to existing operating agreements. This contractual provision is effective even with regard to unrecorded operating agreements in "race" jurisdictions.⁵⁰ As between the nonoperator and the operator, the lien granted by the operating agreement is usually valid even though not acknowledged, recorded or perfected.

The lien provisions of the 1989 AAPL form operating agreement have been revised and improved over prior forms. For instance, the operator's lien provided by the 1977 and 1982 AAPL forms secures only the obligation to pay expenses. The lien provisions under the 1989 AAPL form secure performance of all of each party's "obligations under this agreement." Presumably this language is sufficient to include

46. See generally *Page v. Fees-Krey, Inc.*, 617 P.2d 1188 (Colo. 1980) (en banc) (applying Colorado law); *MBank Abilene, N.A. v. Westwood Energy, Inc.*, 723 S.W.2d 246 (Tex. Civ. App. 1986, no writ).

47. See *In re Century Offshore Management Corp.*, 119 F.3d 409, 412-13 (6th Cir. 1997).

48. See *MBank Abilene*, 723 S.W.2d at 253.

49. See U.C.C. § 9-305 (1997).

50. See *Century Offshore*, 119 F.3d at 414.

each party's obligation to perform under a gas balancing agreement. It is probably best, however, to cross reference the gas balancing agreement to the lien provisions in the operating agreement.⁵¹

B. Statutory Mineral Contractors' Liens

1. The Nature of the Lien

The most singular attribute of the statutes creating liens for oil and gas contractors is that they grant a perfected lien to mechanics and materialmen immediately and automatically upon the performance of labor or services or providing materials to oil and gas properties. The contractors' lien statutes of the major producing states require a subsequent filing by the lien claimant in order to preserve the priority and validity of the lien. Until then, it constitutes a "secret lien" and means potential trouble for secured lenders.

A general discussion of statutory contractors' liens follows. References are made to the statutes of certain producing states and cases decided in various jurisdictions to give an impression of the issues that arise and the different answers that are possible from one state to another. The following discussion does not include an exhaustive discussion of any state's statutes or all of the issues that can arise under these statutes.

2. Persons Entitled to the Lien

a) Contractors

The first prerequisite to obtaining the contractors' lien is that the lien claimant must have performed labor or service in drilling a well or operating an oil and gas property or must have provided materials used in drilling a well or operating an oil and gas property. However, only debts are secured. Therefore, a drilling contractor that is to earn an interest in the well it is drilling may not be owed the requisite debt obligation to render the contractors' lien statutes applicable.⁵²

While the contractors' lien statutes in each state will vary, such statutes generally require that labor or materials must have been provided under contract with the owner of the land or the owner of an interest in an oil, gas or mineral leasehold interest in the land.⁵³ Prior to the 1995 amendments of the Louisiana statute, there was no requirement that the lien claimant act under a contract with the owner of the oil and gas leasehold or with anyone else. The only prerequisite was that the claimant provide labor or materials for the drilling or operation of an oil and gas well.⁵⁴ However, the

51. For a comprehensive treatment of the operator's lien, see Andrew B. Derman, *Protecting Oil and Gas Lien and Security Interests: Use of Memorandum of Operating Agreement and Financing Statement*, (ABA Nat'l Resources L. Sec. Monograph No. 6) (1987).

52. See *Amoco Prod. Co. v. Horwell Energy, Inc.*, 969 F.2d 146, 147 (5th Cir. 1992); *Burg v. Ruby Drilling Co.*, 783 P.2d 144, 152 (Wyo. 1989). But see *JHJ Ltd. I v. Chevron USA, Inc.*, 580 F. Supp. 6, 8 (M.D. La. 1983) (holding that subcontractor who was not paid by the drilling contractor earning under a farmout was entitled to the lien).

53. See, e.g., COLO. REV. STAT. § 38-24-101 (Supp. 1981); N.M. STAT. ANN. § 70-4-1 (Michie 1978); 42 OKLA. STAT. § 144 (1991); TEX. PROP. CODE § 56.001 (West 1997).

54. See Stephen J. McGary, *Mechanics and Materialmen's Liens in the Louisiana Oil Patch*, 29 LA.

recent amendments seem to have imposed a requirement that the contractor perform under a contract with an owner of an interest.⁵⁵ Judicial gloss has rendered the Texas statute unique by limiting the availability of the statute to laborers who perform physical or manual labor, so one employed simply to watch a lease is not entitled to the lien.⁵⁶ However, in Oklahoma, a person hired to guard equipment on a lease is entitled to the lien.⁵⁷ In Texas, geologists who generate and evaluate prospects and lawyers who examine title to the lease are not entitled to the lien; but a desperate geologist who was present at the drill site supervising drilling operations, examining core samples, etc., may be able to make a more persuasive argument for applicability of the lien statute. On the other hand, the Oklahoma statute specifically grants the lien to geologists and petroleum engineers if they perform work under written contracts.⁵⁸ Kansas courts have determined that professional services provided by geologists are "labor" within the meaning of the lien statute, and therefore a lien in that case is also proper.⁵⁹

b) Operators

Presumably, an operator under a "standard form" operating agreement qualifies as one furnishing materials and performing labor and as such is entitled to the lien to secure the obligations of non-operators to pay the portion of joint interest billings attributable to materials and labor (but not the portion attributable to legal fees, administrative overhead, etc.). Courts in Louisiana,⁶⁰ Illinois,⁶¹ and Oklahoma⁶² have expressly held that the operator is entitled to the lien. Montana also affords protection to the operator of a property unitized pursuant to statute,⁶³ in addition to the oil and gas contractors' lien statute in force in Montana.⁶⁴ The statute provides that such operator has "a first and prior lien upon each owner's oil and gas rights and his share of unitized production to secure the payment of each owner's proportionate part of developing and operating costs in the unit area."⁶⁵

BJ. 67, 69 (1981). In the case of *Odom v. McClanahan*, 196 So. 382 (La. App. 1940), the contractors' lien was upheld even though the person with whom the lien claimant contracted was claiming under an invalid lease. See *id.* at 386. Since there was no lease, the court held that the lien attached to the well that was drilled. See *id.*

55. See LA. REV. STAT. ANN. § 9.4861(10) (West 1995) (defining "contractor").

56. See *Bell Oil & Ref. Co., v. Price*, 251 S.W. 559, 562 (Tex. Civ. App. 1922, writ ref'd).

57. See *Colonial Supply Co. v. Smith*, 272 P. 879, 880-81 (Okla. 1928).

58. See 42 OKLA. STAT. § 144 (1991).

59. See *DaMac Drilling, Inc. v. Shoemake*, 713 P.2d 480, 485-86 (Kan. Ct. App. 1986).

60. See *Compadres, Inc. v. Johnson Oil and Gas Corp.*, 547 So. 2d 382, 387 (3d Cir. 1991); *Kenmore Oil Co. v. Delacroix*, 316 So. 2d 468 (La. Ct. App. 1975).

61. See *John Carey Oil Co. v. W.C.P. Investments*, 511 N.E.2d 727, 731 (Ill. Ct. App. 1987).

62. See *Amarex, Inc. v. El Paso Natural Gas Co.*, 772 P.2d 905, 908 (Okla. 1989).

63. See MONT. CODE ANN. § 82-11-201 (1981).

64. See *id.*

65. *Id.*

c) *Subcontractors*

The states that require that the lien claimant provide labor or materials under a contract with an owner of the leasehold estate have separate statutes granting liens to subcontractors.⁶⁶ There is more variety among the states regarding the treatment of subcontractors than on any other issue. This area also reflects the greatest divergence from the mechanics and materialmen statutes generally applicable to other real estate improvements. For this reason the results are often "counter-intuitive" to practitioners not familiar with the oil and gas contractors' lien statutes.

Typically, a subcontractor has a lien only to the extent that the original contractor has a lien. Thus, if the contractor has been paid by the operator or lessee and has simply failed to pay his subcontractors, then those subcontractors have no liens.⁶⁷ In Texas, however, the owner is subject to a lien by a subcontractor where the owner receives notice of the subcontractor's claim prior to paying the contractor in full.⁶⁸ Since the operator is an independent contractor in Texas, an unpaid laborer or materialman should be able to assert the subcontractor's lien against the interest of any non-operator who is not current in his payment to the operator of joint interest billings.⁶⁹ There is apparently no statutory impediment to a subcontractor asserting a lien in Louisiana even though the operator of the oil and gas lease paid the primary contractor in full.

The subcontractor must provide services or materials to the property it seeks to encumber. The so-called "furnisher of a furnisher" cannot assert a lien against the owner. In *Baker Chemicals, Inc. v. TXO Prod. Co.*,⁷⁰ the court held that where a supplier sold drilling equipment to the supplier of a well operator, and made delivery to the intermediary, no lien could attach to the interest of the owner.⁷¹ A company that provides rental equipment to a contractor who ultimately uses it to drill an oil and gas well is not entitled to a lien absent an agreement between the parties that the equipment was provided for that express purpose.⁷²

66. See, e.g., COLO. REV. STAT. § 38-24-102 (Supp. 1981); MONT. CODE ANN. § 71-3-1003 (1981); N.M. STAT. ANN. § 70-4-3 (Michie 1978); 42 OKLA. STAT. § 145 (1991); TEX. PROP. CODE § 56.002 (West 1997).

67. See *Dunigan Tool & Supply Co. v. Burris*, 427 S.W.2d 341, 343-44 (Tex. Civ. App. 1968, writ ref'd n.r.e.); *Josey Oil Co. v. Ledden*, 20 P.2d 582, 583 (Okla. 1933).

68. See *Energy-Agri Prod. Inc. v. Eisenman Chem. Co.*, 717 S.W.2d 651, 653 (Tex. App. 1986, no writ).

69. See *Energy Fund of America, Inc. v. GET Serv. Co.*, 610 S.W.2d 833, 836 (Tex. Civ. App. 1980), *aff'd in part, rev'd in part*, 616 S.W.2d 184 (Tex. 1981).

70. 556 So. 2d 226 (La. Ct. App. 1990).

71. See *id.* at 228.

72. See *P & A Well Serv., Inc. v. Blackie's Power Swivels, Inc.*, 507 So. 2d 280, 282 (La. Ct. App. 1987).

3. Property Subject to the Lien

a) Leases

(1) Less Than the Entire Working Interest

The contractors' lien attaches to leases or leasehold interests and is not limited to wells or the proration units around wells, so the lien claimant who performs labor or provides materials for a well will acquire a lien in other wells on the same lease and in nonproductive acreage covered by the lease.⁷³ In Texas⁷⁴ and Colorado,⁷⁵ the lien attaches only to the leasehold interest of the owner who contracts with the lien claimant. In these states, if the person who contracts with the lien claimant owns an equitable interest or a legal interest that is subject to forfeiture upon a condition subsequent (e.g. under a "drill to earn" farmout), and the interest of that owner fails to ripen into legal title or the condition subsequent occurs causing forfeiture of such person's interest in the lease, then the lien claimant does not have a lien on the lease. However, the lien will still attach to any equipment owned by the person who contracted with the lien claimant.⁷⁶ If the person who contracts with the lien claimant owns only an undivided interest in the oil and gas lease, the lien does not attach to the interest of the other co-owners unless the lien claimant can establish that the co-owners are mining partners or joint venturers or that an agency relationship exists.⁷⁷

Lien claimants should always explore the relationship of the co-owners expecting to find a joint venture or an agency relationship. For example, if the operator also acts as a general partner of a non-operator that is a partnership, a lien claimant may be able to successfully argue that the operator's activities were carried out in its capacity as general partner rather than in some other capacity. But while lien claimants and other creditors frequently and vehemently assert that co-owners of oil and gas leases are mining partners or joint venturers, it is well settled under Texas law that any of the co-owners of the working interest in a lease can act as the operator under an agreement with the other co-owners designating the operator as an independent contractor, and, so long as their conduct is not inconsistent with that characterization, the working interest owners will not be joint venturers.⁷⁸

It should be noted, however, that in Texas the lien will attach to the entire interest to which the person contracting with the contractor holds *record title*, so if the operator of the property holds record title and the non-operators have unrecorded beneficial or equitable interests, the interests of the non-operators will be subject to the lien.⁷⁹ When an operator who holds legal title to interests that are owned

73. See *Mercantile Nat'l Bank v. McCullough Tool Co.*, 259 S.W.2d 724, 728-29 (Tex. 1953).

74. See TEX. PROP. CODE § 56.003 (West 1997).

75. See COLO. REV. STAT. § 38-24-101 (Supp. 1981).

76. See TEX. PROP. CODE § 56.003(3) (West 1997).

77. See *Youngstown Sheet & Tube Co. v. Penn.*, 355 S.W.2d 239, 241 (Tex. Civ. App. 1962), *modified on other grounds*, 363 S.W.2d 230 (Tex. 1962).

78. See *Ayco Dev. Corp. v. GET Serv. Co.*, 616 S.W.2d 184, 186 (Tex. 1981).

79. See *Energy Fund of Am., Inc. v. GET Serv. Co.*, 610 S.W.2d 833, 836 (Tex. App. 1980), *aff'd in part, rev'd in part*, 616 S.W.2d 184 (Tex. 1981)

beneficially by non-operators becomes a debtor in bankruptcy, the lien claimant's rights with regard to the full interest to which the operator holds record title are not affected by the exclusion of the non-operators' beneficial interests from the debtor's estate under section 541(d) of the Bankruptcy Code. If a trustee in bankruptcy is not able to exert the "strongarm" provision of section 544 to avoid the unrecorded interests of the non-operators because their interests are excluded from the debtor's estate by section 541(d), the lien claimant may ironically have more clout as a "bona fide lienholder" under state law than does the trustee in bankruptcy as the "super bona fide purchaser" under section 544.

(2) The Entire Working Interest

Unlike Texas and Colorado, the statutes in Oklahoma, New Mexico and Louisiana provide for the contractors' lien to attach to the entire working interest in the lease. There are provisions that protect an owner of a working interest in a lease who does not own an interest in the well to which the materials or labor were furnished. The New Mexico statute provides that the lien shall not "extend to the property, leasehold or working interest of any owner who does not have a working interest in the well upon which the labor was performed or for which the materials were furnished or hauled."⁸⁰ In Oklahoma, New Mexico, and Louisiana, a non-operator may find himself in the position of having paid his share of the expenses to the operator, yet having to pay a second time directly to the lien claimant in order to have the contractors' lien removed from the lease.

In the states where the lien attaches to the entire working interest (including Louisiana, Oklahoma and New Mexico), rather than only the interest of the person with whom the lien claimant contracts, there may be provisions exempting production payments and overriding royalty interests from the lien. The Oklahoma statute exempts from the lien "valid bona fide reservations of oil and gas payments or overriding royalty interests executed in good faith."⁸¹ This exemption seems to be limited to production payments and overriding royalties that have been reserved by predecessors in interest, but overriding royalties and production payments which are "carved out" by the present owner of the working interest may not be exempt. The Montana statute's exemption language is broader and exempts "oil payments" and overriding royalty interests "created prior to the date the first item of material or services are furnished or the date the first labor is performed."⁸² The New Mexico statute does not expressly exempt overriding royalty interests or production payments at all, but instead the lien attaches to "the whole of that land, oil and gas permit, leasehold, lease for oil and gas purposes" but not to the "underlying fee or royalty interests."⁸³ The Louisiana and Montana statutes, by limiting the lien to "the working

80. N.M. STAT. ANN. § 70-4-1 (Michie 1978). See also MONT. CODE ANN. § 71-3-1002(2) (1981).

81. 42 OKLA. STAT. § 144 (1991).

82. MONT. CODE ANN. § 71-3-1002(3) (1981).

83. N.M. STAT. ANN. § 70-4-1 (Michie 1978).

interest" in wells and leases, probably exempt overriding royalty interests and production payments from the lien.⁸⁴

b) Equipment and Fixtures

Generally, the lien attaches to all equipment and fixtures present on the lease or land when the labor or material is provided. In Colorado, however, the lien attaches to all fixtures on the lease when the labor or materials is provided and to all equipment furnished by the lien claimant, but not to other equipment.⁸⁵ In Texas (and Colorado, with the limitation noted) the lien will attach only to that portion of the equipment and fixtures on the lease that is owned by the person contracting with the lien claimant, so the claimant's lien will not attach if equipment or fixtures located on the lease have been borrowed or rented.⁸⁶ If a leasing transaction is really a subterfuge for a financing arrangement, the equipment or fixtures may be subject to the lien.⁸⁷

c) Severed Production and Proceeds

In Montana,⁸⁸ Oklahoma,⁸⁹ and Louisiana,⁹⁰ the lien does attach to severed oil and gas and the proceeds therefrom. The lien does not attach to severed oil and gas production or the proceeds therefrom under the statutes in Colorado,⁹¹ New Mexico⁹² or Texas.⁹³ Since oil and gas properties are depleting assets, contractors in the states where the lien does not encumber production can watch the leases encumbered by their liens be depleted while enforcement and foreclosure actions are pending. In *Abella v. Knight Oil Tools*,⁹⁴ contractors faced with this predicament were able to use a receivership proceeding to trap proceeds of production for their benefit even though the Texas statute did not afford them any lien rights in the production.

4. Filing Procedures for Preserving the Lien

a) The Lien Statement

While the contractors' lien statutes in force in the various states differ in many regards, they all require the lien claimant to make a filing in the county records of the county where the oil and gas property is located in order to *preserve* the priority of the lien. The lien is "perfected" automatically with the furnishing of the labor or

84. See LA. REV. STAT. ANN. § 9:4862 (West 1995); MONT. CODE ANN. § 71-3-1002(1) (1981).

85. See *Gearhart-Owen Indus., Inc. v. Panhandle Prod. Co.*, 624 P.2d 355, 357 (Colo. Ct. App. 1980).

86. See *Duty v. Texas-Cushing Oil & Dev. Co.*, 242 S.W. 495, 496-97 (Tex. Civ. App. 1922); *Osborn v. Masco, Inc.*, 73 P.2d 113, 115 (Okla. 1937).

87. See *Chambers v. Nation*, 497 P.2d 5, 7 (Colo. 1972) (en banc).

88. See MONT. CODE ANN. § 71-3-1002(1) (1981).

89. See 42 OKLA. STAT. § 144 (1991).

90. See LA. REV. STAT. ANN. § 9:4871 (1995).

91. See *Chambers*, 497 P.2d at 5.

92. See N.M. STAT. ANN. § 70-4-1 (Michie 1978).

93. See TEX. PROP. CODE § 56.003 (West 1997).

94. 945 S.W.2d 847, 850 (Tex. App. 1997, no writ).

material, and the filing is necessary for the continued perfection and validity of the lien. The contractors' lien statutes are basically uniform in their provisions prescribing the contents of the lien statement, and the elements listed below will satisfy the requirements of Colorado, Oklahoma, Louisiana, Montana, New Mexico and Texas. In these states the lien statement must:

1. Be verified by affidavit.
2. Set forth the items furnished or labor performed and the amount claimed therefor. (In the absence of fraud, overstating the amount owed will not invalidate the lien.⁹⁵)
3. State the dates of performance or furnishing.
4. State the name of the owner of the lease or land. (In Texas, this information is required only if such name is known.⁹⁶)
5. Provide name of lien claimant and his mailing address.
6. Contain a description of the lease or land. Presumably, the legal standards regarding the sufficiency of the land description are the same as are imposed on conveyances by the Statute of Frauds under the laws of the state involved. In Louisiana, the lien statement must "contain a description of the leased property of such nature as to make the leased property reasonably subject to identification."⁹⁷ In Texas, if the lien claimant is claiming the subcontractors' lien, the lien statement must contain, in addition to all of the elements listed above, the name of the person for whom the labor was performed or the material furnished (the contractor) together with a statement that the lien claimant has given the owner of the land or leasehold interest notice in writing that the subcontractors' lien is claimed.⁹⁸

b) Time Period for Filing the Lien Statement

While the contractors' lien is perfected immediately and automatically upon the furnishing of material or labor, the lien's priority and validity depends on timely filing of a lien statement. The time within which the lien statement must be filed begins to run with the furnishing of the labor or material. However, most, if not all, of the statutes provide that continuous activity by a contractor will constitute a "single contract," and that the time period within which the lien statement must be filed begins to run with the *last* furnishing of labor or materials. In Texas⁹⁹ and Montana,¹⁰⁰ if labor or material is furnished by a contractor within six months from a previous "furnishing" of labor or materials by the same contractor, then the two furnishings are a single contract. But note that in Texas, if labor is performed by the day or week, each week's labor shall constitute a single contract.¹⁰¹ In New Mexico, the two furnishings must be within 120 days of each other to constitute a single contract.¹⁰² The Colorado statute contains less specific provisions which merely

95. See *Mercantile Nat'l Bank v. J. Thos. Driscoll, Inc.*, 195 So. 497, 502 (La. 1940).

96. See TEX. PROP. CODE § 56.022 (West 1997).

97. LA. REV. STAT. ANN. § 9:4862 (West 1995).

98. See TEX. PROP. CODE § 56.022 (West 1997).

99. See TEX. PROP. CODE § 56.004 (West 1997).

100. See MONT. CODE ANN. § 71-3-1008 (1981).

101. See TEX. PROP. CODE § 56.004 (West 1997).

102. See N.M. STAT. ANN. § 70-4-2 (Michie 1978).

provide that a "running account" is a single contract.¹⁰³ The Oklahoma statute does not expressly address the "single contract" issue, but cases construing the statute hold that an open account will constitute a single contract.¹⁰⁴

c) Additional Hurdles

Generally, the filing of the lien statement is all that is required to preserve the lien; however, under the Texas statute, ten days before they file the lien statement, subcontractors must give written notice to the owners of the land or oil and gas lease that the subcontractors' lien is claimed. This amount must contain the amount owed the person who owes the subcontractor and a description of the land or oil and gas leasehold interests subject to the lien.¹⁰⁵

The states in which the contractors' lien attaches to severed oil and gas and the proceeds therefrom require the lien claimant to serve notice on the purchaser of production as a prerequisite to the lien being effective against such purchaser.¹⁰⁶

5. Priorities

a) Other Contractors' Liens

Generally, all lien claimants with properly preserved liens are given equal rank without reference to the date of filing or the date on which the labor or materials were furnished. Each claimant shares in the property to which his lien attaches pro rata with the other lien claimants with liens on the same property. In Colorado,¹⁰⁷ Louisiana¹⁰⁸ and New Mexico,¹⁰⁹ laborers have priority over other contractors' lien claimants. In Texas and Oklahoma all lien claimants have the same priority.¹¹⁰

b) Other Competing Liens

As noted above, the date on which labor or materials are first furnished marks the inception of the lien. A mortgage on the land or oil and gas lease which was properly perfected prior to the inception of the oil and gas contractors' lien is prior in right to the contractors' lien. However, since all, or almost all, of the contractors' lien statutes provide for continuous (i.e., intermittent) activity by a contractor to constitute a single

103. COLO. REV. STAT. § 38-24-104(2) (Supp. 1981).

104. *See* Chickasha Cotton Oil Co. v. Standard Lumber Co., 52 P.2d 816, 818-19 (Okla. 1935); Wm. M. Graham Oil & Gas Co. v. Oil Well Supply Co., 264 P. 591, 595-96 (Okla. 1927).

The time periods within which the contractors' lien statutes of selected states require the affidavit to be filed are listed: COLO. REV. STAT. § 38-24-104 (Supp. 1981) (six months); 42 OKLA. STAT. § 146 (1991) (four months); LA. REV. STAT. ANN. § 9:4865 (West 1995) (180 days); MONT. CODE ANN. § 71-3-1004 (1981) (six months); MONT. CODE ANN. § 82-11-212 (1981) (90 days for those claiming the lien granted to unit operators by this section); N.M. STAT. ANN. § 70-4-4 (Michie 1978) (120 days for original contractors and 90 days for others); TEX. PROP. CODE. § 56.021 (West 1997) (six months).

105. *See id.* § 56.022.

106. *See* 42 OKLA. STAT. § 144.1 (1991); LA. REV. STAT. ANN. § 9:4869 (West 1995); MONT. CODE ANN. § 71-3-1011 (1981).

107. *See* COLO. REV. STAT. § 38-24-102 (Supp. 1981).

108. *See* LA. REV. STAT. ANN. § 9:4862 (West 1995).

109. *See* N.M. STAT. ANN. § 70-4-11 (Michie 1978).

110. *See* Lane-Wells Co. v. Continental-Emsco Co., 397 S.W.2d 217, 220 (Tex. 1965).

contract, the holder of a contractual lien may not know that his lien is competing with a contractors' lien until long after funds are advanced in reliance on the presumed priority of the contractual lien.

Perhaps the most important question for the secured lender regarding any state's contractors' lien statute is whether the priority of the lien of the contractor who periodically provides services or materials is established when that contractor first provided materials or services or when he provided the materials or services that are the subject of the unpaid invoices. In Louisiana¹¹¹ and Kansas,¹¹² the inception of a statutory lien is established when the contractor first provided services without regard to whether the earliest services have been paid for. This issue is not clearly answered by each state's statute. Thus secured lenders should be wary that this "prehistoric" inception date may be possible in other jurisdictions. Permitting the "regular provider" to establish his priority months or even years earlier puts a secured lender contemplating making a loan in an untenable position. It is not sufficient for the secured lender merely to confirm that the operator/borrower is current in its trade payables. If the secured lender is to be absolutely certain that it has a first priority lien, subordinations must be obtained from any contractor who has provided materials or services during the time period that constitutes the "continuous activity" definition of a single contract under the relevant state statute. The only other fail-safe approach for the borrower is to fire the current contract pumper, water hauler and other "regular providers" and replace them with providers who cannot establish a priority that primes the secured creditor.

6. *Foreclosure of the Lien*

None of the contractors' lien statutes contemplates a nonjudicial foreclosure. The Colorado and New Mexico statutes contain specific limitation periods for filing the foreclosure action. In Colorado, the action must be filed within six months of the filing of the lien Statement.¹¹³ In New Mexico, the action must be filed within two years of the filing of the lien statement if an agreement to extend credit exists; otherwise, the action must be filed within one year of the filing of the lien statement.¹¹⁴ In the states where the contractors' lien statute does not contain a special limitation period, presumably, the applicable limitation statute is that which is applicable to the underlying indebtedness. Section 70-4-8 of the New Mexico Statutes specifically negates the owner's right of redemption; but absent such a specific negation of the right of redemption, an owner will presumably have the same right of redemption it would have if any other lien were foreclosed.¹¹⁵

111. See *In re Century Offshore Management Corp.*, 83 F.3d 140, 141 (6th Cir. 1996).

112. See *Pioneer Operations Co. v. Brandeberry*, 789 P.2d 1182, 1188 (Kan. Ct. App. 1990).

113. See COLO. REV. STAT. § 38-24-105 (Supp. 1981).

114. See N.M. STAT. ANN. § 70-4-7 (Michie 1978).

115. See N.M. STAT. ANN. § 70-4-8 (Michie 1978).

C. Oil and Gas Products Lien¹¹⁶

The states of Kansas,¹¹⁷ New Mexico,¹¹⁸ Oklahoma,¹¹⁹ Texas¹²⁰ and Wyoming¹²¹ have enacted statutes that afford to royalty owners, producers and other interest owners a statutory security interest in their oil and gas production to secure payment of the purchase price for that production. Because the liens are intended to benefit the producer, the production loan lender is not concerned with the producer's lien. It bolsters rather than threatens the position of the producer's secured creditors. However, the first purchasers' lender has a very different view of these statutes.

The New Mexico statute was enacted in 1973, but the other four states' statutes were in response to the failures and bankruptcies of several crude oil purchasers in the early 1980s, including Basin, Inc., Brio Petroleum, Inc., Compton Petroleum Corp. and Gratex Corp., who all filed for bankruptcy in 1982.¹²²

The Texas statute was a direct response by petroleum producers and royalty owners to the treatment they received in those bankruptcy proceedings. Generally, when a purchaser sought the protection of the Bankruptcy Code, the producers and their royalty owners comprised the largest group of unsecured creditors. The purchasers were highly leveraged and their secured creditors had security interests in all of the assets of the purchasers, including the oil, gas, and petroleum products that comprised the inventory of the purchasers, the accounts receivable due from second purchasers, and all funds in the debtors' bank accounts. By granting to the mineral interest owners a purchase money security interest in the production (and the proceeds therefrom), the Texas statute, and those that are patterned after it, were intended to transfer from the interest owners to the other creditors of the purchaser the risk of loss that will result from a purchaser going into bankruptcy or becoming insolvent. By transferring this risk, these statutes have naturally diminished the ability of first purchasers to obtain financing, since at any given time the purchaser's inventory, accounts receivable and a portion of its bank deposits will generally be encumbered by the purchase money security interest of the mineral interest owners.

These statutes fall into two categories: straightforward statutory liens and liens contained in non-uniform amendments to the respective state's version of the U.C.C. The New Mexico statute basically created a statutory purchase money security interest out of whole cloth with the statute resembling the statutory mechanic's and materialmen lien statutes. Oklahoma emulated New Mexico with some important modifications. This approach is not surprising in view of the similarities in how the

116. For a comprehensive treatment of these lien statutes, see Terry I. Cross, *Oil and Gas Product Liens-Statutory Security Interest for Producers and Royalty Owners Under the Statutes of Kansas, New Mexico, Oklahoma, Texas and Wyoming*, CONSUMER FIN. L.Q. REP., Fall 1996, at 418.

117. See KAN. STAT. ANN. § 84-9-319 (1991).

118. See N.M. STAT. ANN. § 48-9-1 (Michie 1978).

119. See 52 OKLA. STAT. § 548.1 (1991).

120. See TEX. BUS. & COM. CODE § 9-319 (West 1997).

121. See WYO. STAT. ANN. § 34.1-9-319 (Michie 1997).

122. See Cynthia G. Grinstead, *The Effect of Texas U.C.C. Section 9.319 on Oil and Gas Secured Transactions*, 63 TEX. L. REV. 311, 322-23 (1984).

debts secured by these liens and by mechanics' liens arise. The Texas statute, on the other hand, attempted to conjure a consensual, contractual security interest from the typical production marketing transaction by "deeming" standard conveyancing and marketing instruments to fulfill the documentation requirements imposed by article 9 of the U.C.C.

The reason the section 9-319 statutes go through tortuous maneuvers to simulate an article 9 security interest is the superior treatment accorded consensual security interests over statutory liens under the Bankruptcy Code,¹²³ the Federal Tax Lien Act¹²⁴ and a federal statute establishing relative priority of debts to the United States Government in nonbankruptcy insolvency situations.¹²⁵ Because the section 9-319 liens in fact arise through the operation of the statute rather than as a consequence of consensual agreement, there is some risk that the various statutory provisions that distinguish between statutory liens and consensual liens could still be construed to apply to the section 9-319 liens as if they were statutory liens. The Bankruptcy Code defines "statutory lien" as:

[a] lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute;¹²⁶

In bankruptcy, the resolution of whether the section 9-319 liens "arise solely by force of a statute" will determine whether the drafters succeeded in legislating a nonstatutory lien. The Texas statute was enacted in 1983, Wyoming in 1986, Oklahoma in 1988, and Kansas in 1991. Because of their relatively brief history, and more importantly the respite from bankruptcy filings by purchasers of crude oil and gas, there have been very few judicial decisions construing these statutes.

VIII. Foreclosure

The nature of oil and gas collateral creates several issues for a creditor seeking to recover value lost as the result of a borrower default through a foreclosure mechanism. These problems are compounded for counsel who enforce security interests in several states. The following section first details the basic issues, rights, and remedies that are available to the oil and gas creditor upon a default,¹²⁷ and secondly, discusses some

123. See 11 U.S.C. §§ 507, 545, 724 (1994 & Supp. IV 1998).

124. I.R.C. § 6321 (1994).

125. See 31 U.S.C. § 3713 (1994). For a statement of the reasons for engrafting the section 9-319 security interest in article 9, see the Official Comment by Prof. Colin Kaufman following TEX. BUS. & COM. CODE § 9-319. See also Grinstead, *supra* note 122 (citing interviews with Prof. Kaufman, primary author of the Texas statute and A. Scott Anderson, attorney for Texas Independent Producers and Royalty Owner Association, which supported the section 9-319).

126. 11 U.S.C. § 101(39) (1994).

127. Though outside the scope of this section, counsel must be aware that the concept of a "default" is amorphous in certain states, and must be certain that a "default" has occurred under the laws of the particular jurisdiction that is sufficient to trigger enforcement rights.

of the more specific issues that local counsel should address.

Under section 9-501, a creditor may foreclose on several grounds including: (1) article 9 itself, (2) a suit on the underlying debt; or (3) under the provisions of any validly existing security agreement. In certain states the creditor can pursue several of these options cumulatively and/or simultaneously while in others it must elect one.

Though by its terms a creditor may opt out, article 9 provides the greatest breadth of options. For example, under article 9, where one security agreement covers both real and personal property collateral, the lender may (a) proceed under the U.C.C. as to the personalty, and the relevant state's real property law as to the realty or (b) use the applicable real property foreclosure mechanism as to the *whole*.¹²⁸ Typically, the creditor holding a lien in producing oil and gas properties will elect to foreclose on the "mixed package" of realty and personalty under the respective state's real property foreclosure laws.¹²⁹ Nevertheless, should the lender not recover the full value of its claim under such real property law, the lender may pursue any of the avenues of recovery set forth in article 9. In no event, however, may the lender recover anything greater than the value of the claim.

The oil and gas debtor cannot extinguish the creditor's security interest by disposing of the collateral except in the case of a sale of production or other personalty in the ordinary course of business.¹³⁰ In the event of a sale or disposition of collateral by the debtor subject to the creditor's security interest, the creditor may proceed against either: (i) the *debtor*, to collect on the debt itself or the identifiable proceeds of the collateral under the U.C.C.; or (ii) the *purchaser* of the collateral under the repossession rules of the U.C.C., or in a common law action for conversion. The multiple remedies of section 9-501, with the exception of a few jurisdictions,¹³¹ are not only

128. U.C.C. § 9-501(d) (1997).

129. The key feature in proceeding under the real property laws is the general lack of the ubiquitous "*commercial reasonableness*" requirement of the U.C.C.

130. See U.C.C. § 9-307(a) (1997).

131. The following states in some way limit the right of a creditor to act on its remedies simultaneously, cumulatively, or both: Arizona, *Ins. Co. of North Am. v. General Elec. Credit Corp.*, 579 P.2d 601, 604 (Ariz. 1978) (defining the two basic avenues of recovery and providing for cumulative, but not simultaneous use); California, *In re Egbe*, 107 B.R. 711, 712 (B.A.P. 9th Cir. 1989) (in the context of a motion to dismiss on res judicata grounds, the court found that remedies under the U.C.C. were cumulative, and therefore res judicata did not apply); Colorado, *Alamosa National Bank v. San Luis Valley Grain Growers*, 756 P.2d 1022, 1025 (Colo. Ct. App. 1988) (holding that remedies under the U.C.C. are cumulative); Florida, *City Fed. Sav. Bank v. Florida Eastern Dev. & Management Corp.*, 536 So. 2d 1057, 1058 (Fla. Dist. Ct. App. 1988) (holding that where a creditor took possession of a defaulted note, the creditor could not simultaneously bring suit on the note); Indiana, *Kruse, Kruse & Mislosko, Inc. v. Beedy*, 353 N.E.2d 514, 536 (Ind. Ct. App. 1976) (no deficiency if creditor sells collateral); Minnesota, *American State Bank v. Jensen*, 353 N.W.2d 652, 654 (Minn. Ct. App. 1984) (no suit for a deficiency if creditor sells collateral); North Dakota, *Production Credit Ass'n of Mandan v. Obrigewitch*, 443 N.W.2d 923, 926 (N.D. 1989) (creditor may not proceed simultaneously); Oklahoma, *Farmers State Bank v. Ballew*, 626 P.2d 337, 339 (Okla. Ct. App. 1981) (creditor may apply remedies cumulatively, but never simultaneously); South Dakota, *In re Hogg*, 76 B.R. 735, 742 (Bankr. D. S.D. 1987) (creditor unable to pursue remedies simultaneously); Tennessee, *Traders Nat'l Bank of Tullahoma v. Brown*, 4 U.C.C. Rep. Serv. 2d (CBC) 1568 (Tenn. Ct. App. 1987) (stating in dicta that the remedial provisions of the U.C.C. were apparently designed to be the exclusive remedies for default under a

cumulative,¹³² but may be acted upon *simultaneously*.

The ability to realize the value of collateral using varying means of recovery provides great flexibility to the lender, a unique advantage under article 9. In a state in which a lender can act on the available remedies simultaneously, the lender could take possession of collateral under section 9-502, hold a foreclosure sale pursuant to section 9-504, and at the same time proceed against the debtor under the common law by suing on the underlying obligation. If proceeds of the foreclosure sale are not sufficient, the debtor would still have a claim for a deficiency judgment on the basis of the sale under the U.C.C. Or, as the result of the concurrent judicial proceeding, the creditor could simply execute the judgment on the underlying debt against any non-exempt property of the debtor. Counsel should be aware, however, that in every state the creditor is precluded from using the multiple remedies of the U.C.C. for the purpose of harassing the debtor.¹³³

A. Personal Property Foreclosure

Though it is common for oil and gas creditors to attempt an expeditious sale of all existing collateral and avoid the courts, this desire is tempered by state law requirements designed to protect debtors. In order to maintain its rights to a deficiency, section 9-504 requires that a lender comply with two requirements in conducting a foreclosure on personal property: (1) adequate and proper repossession, and (2) commercial reasonableness.¹³⁴

1. Repossession

A lender must properly repossess collateral before a foreclosure sale may be validly effected. All states provide for the repossession of collateral in two ways: (1) self-help repossession or (2) repossession by judicial action. Self-help repossession is the more common method, as no court authorization is required. However, self-help repossession is available only where no "breach of the peace" will result. Whether by self-help repossession or judicial intervention, however, the property must be in the possession of the creditor prior to the foreclosure sale.

In most states a creditor effectively takes possession when the debtor loses "control" of the collateral. Most states agree that the loss of control may be constructive,¹³⁵

security agreement); Wyoming, *Coones v. FDIC*, 84 P.2d 783, 798 (Wyo. 1993) (creditor cannot act on remedies simultaneously).

132. The terms cumulative and simultaneous are far from interchangeable in this context. The term cumulative means only that a creditor may use its remedies successively until the maximum recovery is obtained.

133. The court in *Glamorgan Coal Corp. v. Bowen*, 742 F. Supp 308 (W.D. Va. 1990), stated the majority rule, that a creditor may pursue remedies simultaneously *and* cumulatively, as long as it is not for the purpose of harassing the debtor. *See id.* at 310. It should also be noted that for purposes of section 9-501, the term "debtor" generally includes guarantors. Therefore, it may be improper to, for example, take possession of collateral and simultaneously attempt to enforce a guaranty.

134. *See* U.C.C. § 9-504 (1997).

135. *See, e.g., Avery v. Chrysler Credit Corp.*, 391 S.E.2d 410, 412 (Cal. Ct. App. 1990) (court found constructive repossession where creditor delivered notice to debtor of intent to repossess and vehicle was destroyed while in the hands of a third party); *Tajalli v. Gharibi*, 758 P.2d 190, 191 (Colo.

and in those states actual physical possession is therefore unnecessary. Nevertheless, there are limitations even where constructive control is recognized. For example, in *Industrial Equipment Credit Corp. v. Green*,¹³⁶ the court found that no repossession had taken place where the creditor merely informed the debtor that a sale of the collateral was to take place on the debtor's property, and the sale was not actually consummated.¹³⁷ In other jurisdictions, the secured party need only render the equipment *unusable* by the debtor in order to constructively repossess it and may thereafter dispose of the collateral *on the debtor's property*.¹³⁸ Custody and control are generally not issues unless a creditor, pursuant to a valid security agreement, has the right to require that the collateral be assembled by the debtor on the debtor's premises. Such assembly requirements are typically valid if the security agreement addresses the topic.¹³⁹ A creditor who exercises its rights pursuant to an assembly provision is generally considered to have properly repossessed the collateral. A creditor is not allowed to pursue any of the above, however, if the creditor has elected to proceed under the real property code of the jurisdiction. As the cases evidence, the critical factor in determining proper repossession is the nature of the collateral. Thus, while declaring that a vehicle is up for sale may not be sufficient, doing so as to a drilling rig may be sufficient.¹⁴⁰

2. Commercially Reasonable Sales

a) Generally

Following a valid repossession all states require that the creditor elect to dispose of the collateral, or keep it in satisfaction of the debt.¹⁴¹ While retaining the collateral gives rise only to certain notice requirements, section 9-504 is more stringent, and generally forces a creditor to choose between a public or private sale.¹⁴² In either event, however, the sale must be carried out in a "commercially reasonable manner."¹⁴³

What is commercially reasonable in any given case will depend largely on the circumstances surrounding the relationship and the underlying transaction. There are few hard and fast rules, and precedent from the respective jurisdiction should be

Ct. App. 1988) (requiring voluntary delivery); *Backes v. Village Corner, Inc.*, 242 Cal. Rptr. 716, 718-19 (Cal. Ct. App. 1987) (court states in dicta that collateral may be sold on the debtor's property without physical repossession).

136. 467 N.E.2d 525 (N.Y. 1984).

137. *See id.* at 526.

138. *See, e.g.*, *Riblet Tramway Co. v. Monte Verde Corp.*, 453 F.2d 313, 319 (10th Cir. 1972).

139. *See, e.g.*, *Winfield v. Society Nat'l Bank*, 845 F.2d 328 (6th Cir. 1988).

140. *See America Furniture Co., Inc. v. Extebank*, 676 F. Supp. 455, 458 (E.D.N.Y. 1987); *Spickler v. Lombardo*, 25 U.C.C. Rep. Serv. (CBC) 1500, 1511 (Pa. Commw. 1978).

141. Though beyond the scope of this article, counsel should be aware that specific notice requirements apply where collateral will be retained pursuant to U.C.C. § 9-503 (1997).

142. Most states require that the creditor elect to proceed via a public or a private sale, with that choice giving rise to additional concerns and requirements depending on the circumstances of the particular case.

143. U.C.C. § 9-504 (1997).

carefully reviewed. Nevertheless, courts generally focus on the type of sale, the type of notice that was provided, to whom that notice was provided, and what choices were made relative to the time, place, and manner of the actual sale. These, and other factors, are discussed below in the context of real property foreclosures. The creditor is generally benefitted by the fact that all states demand that, where a challenge to the reasonableness of the sale is mounted, certain burdens of proof must be met. Indeed, the debtor generally has the ultimate burden of persuasion, though the creditor will face a burden of going forward with evidence where the debtor presents evidence sufficient to support a claim of a specific impropriety with the sale.

Another jurisdictional question for local counsel to consider is who may challenge the commercial reasonableness of a foreclosure sale. As a general rule, those entitled to notice under the relevant U.C.C. rules can raise a challenge. Counsel, therefore, must be aware that where no prejudice exists as to such parties, no suit will lie. However, it must be noted that junior creditors always have the right to challenge the commercial reasonableness of a sale.¹⁴⁴

b) Special Collateral

(1) Accounts and Chattel Paper

A creditor secured by accounts, chattel paper, or general intangibles faces less stringent requirements. The creditor may simply inform the debtor's debtor to remit any payments to the creditor as opposed to the debtor or its agent.¹⁴⁵ The creditor also retains the right to foreclose on the accounts where there is a judgment levy of another party existing on the accounts, as long as the security interest was perfected prior to the judgment levy. As one court held, the rights of the parties are fixed at the time the security interest attaches, not upon default.¹⁴⁶

(2) Intellectual Property

Intellectual property, the attendant patents, trademarks, and licenses are considered general intangibles under article 9. Certain oil and gas lending situations involve such collateral, generally in the form of patented technology, or seismic data owned or licensed by an oil and gas debtor. However, the use of such licenses and data as collateral is a risky practice under current U.C.C. law.

For a security interest to attach under article 9, a debtor must possess "rights in the collateral." Case law suggests sufficient rights are not present where the property at issue is nonassignable or nontransferable, or rendered such by a preemptive state or federal law.¹⁴⁷ When a debtor lacks sufficient rights, the creditor will lack any security interest in the property despite proper filing under the U.C.C. While seismic

144. See *First Nat'l Bank of Steeleville, N.A. v. Erb Equip. Co., Inc.*, 921 S.W.2d 57, 63-64 (Mo. Ct. App. 1996).

145. See U.C.C. § 9-504(2) (1997).

146. See *Shaw-Mudge & Co. v. Sher-Mart Mfg. Co.*, 334 A.2d 357, 360 (N.J. Super. Ct. App. Div. 1975).

147. See BARKLEY CLARK, *THE LAWS OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 2.04[3] (1993).

data licenses are directly implicated by this rule, so are many permits and general intangibles where the property is subject to federal or state regulation.

The solution to the nontransferability problem at the federal level is to file with the appropriate governing agency.¹⁴⁸ The existence of an overlapping state law is more problematic, however. For example, in *In re Delgado*,¹⁴⁹ a lender unsuccessfully attempted to secure a loan by obtaining a security interest in a certificate of deposit funded from monies obtained in a worker's compensation settlement.¹⁵⁰ The court found that state law provided that such funds were not transferable, preempted the U.C.C., and rendered the security interest void.¹⁵¹ This rule may be somewhat more limited in jurisdictions such as Texas.¹⁵²

B. Real Property Foreclosures

For reasons stated above, the oil and gas creditor generally proceeds against producing properties or other collateral that is predominantly realty under the real property laws of the applicable states. In this arena, though, "borrower protection" features are often present. Such laws provide less flexibility for a creditor, but attendant to that is a greater room for error in conducting the sale itself. In this area, there is no requirement that a real estate foreclosure sale be commercially reasonable. Because state laws vary greatly, it is difficult to provide a detailed analysis of real estate foreclosure law except on a state by state basis. This section is limited to a brief analysis of the issues an oil and gas lender should be aware of and consider both prior to and following a default in order to realize the maximum recovery.

1. General Considerations

While the procedures specified for real estate foreclosure are specific and complex, the statutory guidance related to them is relatively clear. From this, it is possible to glean the potential pitfalls, which include a failure to observe the technical requirements of the relevant foreclosure law and the failure to take into consideration certain interests or costs associated with assuming an interest in the property. A foreclosure checklist is attached as Appendix D.

a) Oil and Gas Interests

A creditor who forecloses on a working interest in oil and gas properties must consider that the ownership interest could expose it to liability for the costs related to operations. While most oil and gas operating agreements permit the owners of undivided interests to elect out of certain major operations, other agreements provide for a "majority rule" mechanism that could require the new owner (i.e. former creditor) to fund substantial capital costs. Presumably, pre-funding due diligence has

148. For instance, to properly secure patented technology, a filing is required both at the state level and with the Patent and Trademark Office. See 35 U.S.C. § 261 (1994).

149. 967 F.2d 1466 (10th Cir. 1992).

150. See *id.* at 1467.

151. See *id.* at 1468.

152. See CLARK, *supra* note 147, § 2.04[3].

educated the lender regarding material contractual arrangements burdening the properties. In addition to the cost of operations, there is also the risk of liability for damages to persons and property resulting from accidents.

b) Environmental Concerns

The owner of an oil and gas interest faces substantial liability under both federal and state law if the property involves environmental issues. The most notable federal laws in this area are the Comprehensive Environmental Response Compensation and Liability Act (CERCLA),¹⁵³ the Resource Conservation and Recovery Act (RCRA),¹⁵⁴ and the Oil Pollution Act (OPA).¹⁵⁵ While the OPA is not generally a concern for the onshore properties, some courts do hold that a discharge of oil or threat thereof on land can lead to liability for the property holder. CERCLA is a major concern for creditors seeking to foreclose on an oil and gas property. CERCLA is a strict liability statute that imposes the costs of remediation of a hazardous waste¹⁵⁶ site on several parties, one of whom is the current owner.¹⁵⁷ RCRA is of little concern to the oil and gas interest holder. This is primarily due to the "petroleum exclusion," defined in the statute.¹⁵⁸ However, if hazardous substances were produced on the property, even if unrelated to the oil and gas development, liability can result.

Several states also provide that environmental cleanup costs could be charged to the creditor as the new "owner" of the property. For instance, Texas handles hazardous substances under the Texas Solid Waste Disposal Act¹⁵⁹ and the Texas Natural Resources Code.¹⁶⁰ These statutes provide for remedies similar to those of CERCLA and the RCRA to the extent that the state bears an expense or liability for cleanup. Large fines and the like are possible under the Texas or federal statutes. All environmental concerns may be addressed in the form of an extensive environmental audit (either pre-lending or pre-foreclosure) of both the property and the debtor. Information should be culled from the latter, using the assistance of geologists or other experts.

2. Types of Foreclosure

Three primary methods of foreclosure exist in the several states for foreclosure of real property. Two are clear — judicial and nonjudicial. However, though outside the

153. 42 U.S.C. §§ 9601-9675 (1994 & Supp. IV 1998).

154. 42 U.S.C. §§ 6901-6992k (1994).

155. Pub. L. No. 101-380, 104 Stat. 484 (1990) (codified in scattered sections of 33 U.S.C., 43 U.S.C., 46 U.S.C., and 46 App. U.S.C.).

156. While oil is generally excluded from the scope of CERCLA coverage, drilling fluids may fall within the scope of this definition to the extent that the definition of hazardous substance, as used in the RCRA, is *not* relied upon in defining the terms under CERCLA. *See generally* 42 U.S.C. § 9601(14) (1994) (providing the definition of a "hazardous substance" under CERCLA); 40 C.F.R. § 261.4(b)(5) (1997) (specifically exempting the typical drilling waste from the definition of "hazardous solid waste" and, hence, the definition of "hazardous substance" under CERCLA).

157. *See* 42 U.S.C. § 6901 (1994 & Supp. IV 1998).

158. *See* 42 U.S.C. § 6921(b)(2)(A) (1994); 40 C.F.R. § 261.4(b)(5) (1997).

159. TEX. HEALTH & SAFETY CODE § 361.001-.540 (West 1992).

160. TEX. NAT'L RES. CODE § 91.101-.605 (West 1997).

scope of this section, the majority of states allow a creditor, as is the case under the U.C.C., to sue the debtor on the underlying debt and execute the judgment against the debtor. This method lacks certain protections, however, and as a result, foreclosures of the contractual liens are the course usually pursued by secured creditors. In that context, all states provide the creditor with the option of a judicial foreclosure. However, the same is not true of nonjudicial foreclosures, particularly where the state follows the so-called "one-action" rule.¹⁶¹

a) Judicial Foreclosure

Judicial foreclosure is available to lenders in every state.¹⁶² Several general rules govern the process: there is a requirement of an eventual, judicially mandated sale; the creditor is usually allowed to bid at the sale; there is a possibility for debtor redemption following the sale; and, the creditor has the ability to recover via court action where a deficiency exists.¹⁶³ Judicial foreclosure is by its nature time consuming and expensive, and lacks the flexibility of a nonjudicial foreclosure. For example, most states require: (1) a title search for all possible claimants, (2) filing of a complaint, (3) notice to all parties, (4) rendering of an actual judgement, (5) a notice of sale, (6) the actual sale and issuance of a certificate of sale,¹⁶⁴ (7) report of the sale, possible suit to determine the existence of a deficiency, (8) any chances for redemption after the sale, and (9) the ultimate award of any deficiency.¹⁶⁵ The greatest advantage to the judicial process is the deficiency judgment mechanism. Many states hold that deficiency judgments are not possible following a *nonjudicial* foreclosure.¹⁶⁶ Although judicial foreclosures are time consuming, the creditor also benefits from a process with few pitfalls. Indeed, only two aspects of the process leave any room for errors in judgment.

(1) Parties to the Foreclosure Proceeding

Prior to pursuing a foreclosure, the creditor must determine the proper parties to include in the proceeding for any resulting judgment to have the desired effect. In this regard, some jurisdictions draw a distinction between "necessary" and "proper" parties to a foreclosure proceeding.¹⁶⁷ As to the latter characterization, there is little guidance. However, one court has stated that a "necessary" party is generally

161. See generally GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 578-680 (3d ed. 1993) (discussing foreclosure in the several states). Under this rule, discussed below, in the event of a default the creditor must file a foreclosure action and assert any possible deficiency in that action.

162. Judicial foreclosure is the predominant foreclosure mechanism in Arkansas, Connecticut, Delaware, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Montana, Nebraska, New Jersey, New Mexico, New York, North Dakota, Ohio, Pennsylvania, South Carolina, Vermont, and Wisconsin. See *id.* at 579.

163. See *id.* at 580.

164. A court must confirm that the sale price obtained represented "fair value" for the property sold. See, e.g., *First Fin. Sav. Ass'n v. Spranger*, 456 N.W.2d 897, 898 (Wis. Ct. App. 1990).

165. See, e.g., ARK. CODE ANN. § 18-49-101-107 (Michie 1987); COLO. REV. STAT. § 38-38-101-701 (1990); NEB. REV. STAT. § 25-2138 (1991).

166. See NELSON & WHITMAN, *supra* note 161, at 580.

167. See COLO. REV. STAT. § 38-38-506 (1990); NELSON & WHITMAN, *supra* note 161, at 492-97.

considered a party whose presence is necessary to carry out the goals of a foreclosure.¹⁶⁸ The ultimate goal of a judicial foreclosure is, of course, to extinguish the rights of all other parties in the property to the extent necessary to give the creditor exactly the same interest as that held by the debtor, free of all encumbrances. In contrast, a "proper" party is one whose interest *could* be affected by the proceedings but whose presence is not necessary to realize the ultimate goal. An example of the latter would be a landowner with an easement across the property of the debtor.¹⁶⁹ Careful consideration must be given to those with even a tangential interest. Not making such interest holders parties can leave the purchaser at the foreclosure sale with a clouded title. A party with a right of redemption is an example. Though typically considered only proper parties, if they are left out of the foreclosure proceeding, they will not be bound by the proceeding. The purchaser in that event succeeds to the rights of the creditor and will be subject to the omitted party's redemption rights.¹⁷⁰ Omitting a party with redemption rights in the property could also void the sale outright.¹⁷¹

Failure to join a junior lien holder is similarly problematic, and will generally result in either: (1) a subsequent foreclosure of the junior lien, which revives the senior lien and is subject to it; or (2) a right of redemption which allows the junior lienor to purchase the difference between the sale price and the amount of the senior lien, and then revive the senior lien for its own purposes and foreclose on either to the extent of its contribution.¹⁷² While the senior lienor can protect itself in either situation,¹⁷³ it is important to be aware of this prospect when considering whether to join all known creditors.

(2) Conducting the Sale

Regardless of who is present at the actual sale, there are certain criteria which will, in addition to the concerns stated above, determine if the sale is valid. Case law discussing the subject suggests several factors to consider when conducting a foreclosure sale, and they are analogous to nonjudicial foreclosures, which are discussed below. Despite the congruity of factors, however, foreclosure by action, as stated above, is governed strictly by the applicable statute, and local counsel must

168. See generally *Rott v. Mirrieder*, 441 N.W.2d 645 (N.D. 1989) (holding that only those with properly recorded interests need notice). But see *Pan Am Bank of Miami v. City of Miami Beach*, 198 So. 2d 45 (Fla. Dist. Ct. App. 1967).

169. Another example of this situation is present when a junior creditor forecloses on property without including the senior creditor in the foreclosure proceeding. In that case the senior creditor's rights would not be affected, though it would typically be prudent to include them in the proceedings. See NELSON & WHITMAN, *supra* note 161, at 582-83, 585. It is also necessary, though not demanded in all cases, to include the debtor in the proceedings. Failure to include the debtor will prevent a later deficiency suit against them. See *id.*

170. See *City of St. Paul by Hous. & Redev. Auth. v. St. Anthony Flats, Ltd. Partnership*, 517 N.W.2d 58, 60-61 (Minn. App. 1994); *Akeley v. Miller*, 264 So. 2d 473, 473-74 (Fla. Dist. Ct. App. 1972).

171. See NELSON & WHITMAN, *supra* note 161, at 583.

172. See *id.*

173. See *id.*

adhere to the delineated prerequisites in order to preserve all rights to a deficiency.

b) Nonjudicial or Power of Sale Foreclosure

Nonjudicial or power of sale foreclosure is available in a narrow majority of states.¹⁷⁴ The primary benefit of the nonjudicial sale is the amount of time required for the process. Nonjudicial sales also provide the benefit of less onerous notice requirements. Each state has its procedural requirements¹⁷⁵ and only the concerns that predominate in this area are discussed below.

In general, a creditor must be particularly aware of the potential defects that could render a sale *void* or *voidable*. The consequence of a void sale is that no title, equitable or otherwise, will pass to the purchaser.¹⁷⁶ A voidable sale triggers particular rights of redemption in the party harmed by the improper sale, though legal title is passed, and may give rise to a cause of action against the creditor.¹⁷⁷ Void sales occur, for example, with patent defects, such as a forged mortgage. Voidable sales result primarily from minor defects, ranging from the form of the notice to holding a sale three hours too early under the statute. What is sufficient to serve as the basis for either is purely a matter of jurisdictional interpretation, though the above-mentioned factors serve as a starting point for the courts.¹⁷⁸ And, while it is clearly a minority position, counsel should be aware that courts have utilized the "commercial reasonableness" standard of article 9 in the context of a real property foreclosure.¹⁷⁹

(1) Amount of Sale Price

The rule in most states concerning the bid and sale price of collateral or a foreclosure sale is that mere inadequacy, standing alone, will not serve as the basis to declare a sale improper.¹⁸⁰ A creditor must consider three issues prior to bidding for the property. First, if the bid price is deficient to the extent that it "shocks the conscience," a court may void the sale on that basis alone. Second, if the price is insufficient, fraudulent conveyance issues could arise under section 548 of the Bankruptcy Reform Act.¹⁸¹ Finally, price will play a major role in determining whether or not a deficiency judgment should be decreed, particularly when the

174. The following states presently allow power of sale foreclosures: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, and Wyoming. *See id.* at 610 n.1.

175. This statement is necessarily limited by the enactment of the Uniform Land Transactions Act by the National Conference of Commissioners on Uniform State Laws in 1975, as well as the Multifamily Mortgage Foreclosure Act of 1981, 12 U.S.C. §§ 3701-3717 (1994). Nevertheless, the statutes referenced do not bear a substantial connection to the matters addressed in this article.

176. *See NELSON & WHITMAN, supra* note 161, at 613-16.

177. *See id.* at 535-44.

178. Some possible threshold tests for a voidable sale include (1) substantial defect, or (2) probable unfairness. *See id.* at 517.

179. *Wansley v. First Nat'l Bank of Vicksbury*, 566 So. 2d 1218, 1221 (Miss. 1990).

180. *See Four Strong Winds, Inc. v. Lyngholm*, 826 P.2d 414, 419 (Colo. Ct. App. 1992); *Lake Hillside Estates, Inc. v. Galloway*, 473 So. 2d 461, 465 (Miss. 1985).

181. 11 U.S.C. § 548 (1994).

foreclosing creditor successfully bids for the property.

(2) *Party Foreclosing and Default*

In a nonjudicial foreclosure, the appropriate party must undertake both to foreclose on the property and to conduct the actual sale. This replacement, however, must be distinguished from so-called "proper" parties to include in the proceedings themselves. While the holder of the debt secured by the mortgage or deed of trust is generally the proper party to *effect* the foreclosure, the same is not true where a deed of trust calls for a specific trustee to conduct the sale. If someone other than the designated trustee conducts the sale, it may be void as a matter of law.¹⁸²

With a nonjudicial foreclosure the oil and gas lender must be certain that an actual default has occurred under the terms of the debt instrument. What constitutes a default is initially a matter of contract law; however, case law construing the usage of acceleration clauses in mortgages provides guideposts for the lender.¹⁸³ For instance, a default is always present when a contract's acceleration clause could be properly utilized by the creditor under applicable state law.

(3) *Notice Requirements*

As under the U.C.C., the standards governing nonjudicial foreclosure sales are strictly construed. Where the requirements of the statute are not met, the sale may be void, or at least voidable.

(a) *Type and Persons Entitled*

The proper parties must be notified of the sale.¹⁸⁴ States generally require a posted notice at the courthouse and some form of advertisement in a major periodical or newspaper.¹⁸⁵ States also require filings in the county where the sale is to take place and in all other counties in which the collateral is located. Personal notice is also required in several states. If personal notice is necessary, the relevant statutes require notice to the debtor named in the instrument, as well as to anyone liable for the debt.¹⁸⁶ In addition, all notice requirements may be made more stringent by contractual provisions in a security agreement, deed of trust, or mortgage.¹⁸⁷ In addition, as with judicial foreclosures, the particular statute must be thoroughly reviewed to determine if notice to junior lienholders is required.

182. See *Barksdale v. Strickland & Hazard*, 124 So. 234, 236 (Ala. 1929).

183. See generally *NELSON & WHITMAN*, *supra* note 161 (discussing the circumstances in which acceleration clauses are used to defeat foreclosures).

184. See *Gehrke v. Janowitz*, 223 N.W.2d 107, 108 (Mich. Ct. App. 1974) (invalidating instrument where it appeared to allow foreclosure without notice to the debtor).

185. See *Senters v. Ottawa Sav. Bank*, 503 N.W.2d 639, 641 (Mich. 1993) (holding that statute governs all aspects of notice once power of sale foreclosure elected).

186. See *Burgmeier v. Farm Credit Bank of St. Paul*, 499 N.W.2d 43, 47 (Minn. Ct. App. 1993) (also holding that junior lienholder is not entitled to personal notice).

187. See, e.g., TEX. PROP. CODE § 51.002 (West 1997).

(b) *Contents*

Notice of a foreclosure sale must contain specific information defined by the relevant state law. Such notice will not be proper unless it sufficiently describes the debt, and adequately alerts all interested parties as to the time and place of the sale. In general, there also must be an adequate description of the lien on the property, including the date it was filed, the debtor and creditor, and any trustee charged with the duty to enforce it.¹⁸⁸ The character of the indebtedness must also be described, in order to give the debtor adequate information of the amount and the identity of the current holder of the indebtedness, so that the debtor may have the opportunity to cure if the debt instrument so provides. In certain states a reference to "the indebtedness secured" by a deed or mortgage will be sufficient.¹⁸⁹ The real property covered by the lien must similarly be described. A legal description of the land will always be sufficient; however, this may not be necessary when the mortgage itself is described in detail. Finally, as there must be a default before a foreclosure may be undertaken, many states require that the notice contain a statement of the default, and sometimes the circumstances which gave rise to it.

(4) *Place and Actual Sale*

Holding a foreclosure sale at the improper time will generally not serve as the sole basis to declare a sale improper, absent a substantial deviation from what is allowed by the statute or the instrument governing the lien itself.¹⁹⁰ If the statute and debt instrument fail to establish a specific time frame, counsel must be aware that courts will look to custom and practice in the community.¹⁹¹

However, a creditor should not expect judicial latitude regarding the *location* of the actual sale. Real property must be foreclosed upon, generally, in the county of the state in which it is located or, in the alternative, where the instrument dictates.¹⁹² A failure to foreclose in the proper county,¹⁹³ or a discrepancy from what is set forth in the document could render a sale void.¹⁹⁴

188. See generally *Guardian Depositors' Corp. of Detroit v. Keller*, 282 N.W. 194 (Mich. 1938) (delineating elements required in a typical notification of foreclosure sale); W. MIKE BAGGET, *TEXAS FORECLOSURE LAW & PRACTICE* 55-72 (1984) (for a survey of the rules applicable to foreclosures in the State of Texas, as well as a survey of concerns relevant in all foreclosures).

189. See BAGGET, *supra* note 188, at 55-72.

190. See *Bullock v. Bishop*, 435 So. 2d 24, 26 (Ala. 1983).

191. See BAGGET, *supra* note 188, at 55-72.

192. See *Queen City Sav. & Loan Ass'n v. Mannhalt*, 760 P.2d 350 (Wash. 1988) (interpreting the local statute to provide for the sale of property in multiple counties in one county, provided each property is covered by a single debt instrument).

193. If the property is located in more than one county, a foreclosure must be commenced in each. Failure to so foreclose is manifest error. See, e.g., *Lee v. Magnolia Bank*, 48 So. 2d 515, 517 (Miss. 1950).

194. See NELSON & WHITMAN, *supra* note 161, at 619-20.

C. Federal Law Foreclosure Rules

1. The Soldiers' and Sailors' Relief Act

The Soldiers' and Sailors' Relief Act of 1940¹⁹⁵ (SSRA) protects active duty military personnel from certain legal actions by creditors. The SSRA also applies to persons who were not in the military when they entered into the debtor/creditor relationship, but who are at the time a foreclosure proceeding is commenced. When protected, the debtor possesses several procedural advantages. First, all statutes of limitation are automatically tolled.¹⁹⁶ This directly affects the rights of redemption and of adverse possession. Second, the SSRA functions similarly to the automatic stay of the Bankruptcy Code in that it stays and prevents enforcement of certain civil dispositions.¹⁹⁷ Under section 532, any repossession or foreclosure related actions are stayed while the person is on active duty, provided that the obligations giving rise to the default accrued prior to entry into service. The stay remains in effect until three months after the person is no longer on active duty.¹⁹⁸

2. The Internal Revenue Code

Special rules may apply to foreclosure sales if the federal government is a creditor. If the federal government forecloses on property on its own behalf, it is generally held to the same standards as those established for private individuals and corporations.¹⁹⁹ When the federal government is not directly involved in the foreclosure action, however, the Internal Revenue Code of 1986 (IRC) imposes certain requirements. Under section 7425, the federal government has a right either to be joined as a party where there is a judicial sale, or to be given sufficient notice in all cases where the government has, or claims, an interest in the subject property.²⁰⁰ For notice to be sufficient, the IRC requires that it be delivered within twenty-five days of the sale.²⁰¹ Where notice is not proper, any purchaser will take the property subject to the

195. 50 U.S.C. §§ 501-548, 560-590 (1994).

196. *See id.* § 525.

197. *See id.* §§ 520, 531, 532, 590.

198. *See id.* § 532.

199. This rule is limited in certain states relative to the Federal Deposit Insurance Corporation (FDIC), which enjoys holder in due course status as a matter of law. *See, e.g.,* *Smith v. FDIC*, 800 S.W.2d 648 (Tex. App. 1990, reh'g denied). *But see* *FDIC v. Percival*, 752 F. Supp. 313 (D. Neb. 1990) (creating doubt as to the holder in due course status).

200. *See* I.R.C. § 7425(b) (1994). The section applies specifically to a sale of property on which the United States has or claims a lien, or a title derived from enforcement of a lien, under the provisions of this title, made pursuant to an instrument creating a lien on such property, pursuant to a confession of judgment on the obligation secured by such an instrument, or pursuant to a nonjudicial sale under a statutory lien on such property.

Id.

201. The government also holds a right of redemption when real property is at issue. At any time within 120 days following the sale, the government may redeem the property for value in accordance with 28 U.S.C. § 2410(d) (1994).

government's lien.²⁰² The government has the option to consent to the sale at any time and, if obtained, such consent serves to discharge the lien.

IX. Conclusion

The foregoing discussion includes both a wide ranging overview of oil and gas liens and a more detailed discussion of selected issues. Even the more detailed portions of the article can do no more than identify some of the issues that can arise in specific areas. No article is a substitute for local counsel in the jurisdiction in which the collateral is located. If the collateral were not important, the lender would be making an unsecured loan. Occasionally, a lender may instruct its lawyer that it is not important to use all the "bells and whistles" that may be customary in a particular jurisdiction, so long as an enforceable lien is obtained. Neither this attitude, nor any memory or evidence of it, will be present when the lender needs to enforce the liens. When the loan goes bad, if the lender who faces writing off losses and depleting assets for collateral is also ensnared in litigation or is unable to implement the most expeditious remedies available, that lender will inevitably feel like its lending lawyer let it down. There are places for judicious use of cost-conscious compromises. Secured oil and gas lending is not such a place.

202. See I.R.C. § 7425(b)(1).

APPENDIX A

*Questions for Local Counsel in Connection With
Financing Secured by Producing Oil and Gas Properties*

1. As to which of the following does the Mortgage operate in your State — deed of trust, trust deed, mortgage, open end mortgage or deed to secure debt? If two or more of the foregoing are available in your State, which is preferable for use by lenders?

2. Are any of the following special requirements applicable in your State:

(a) receipt of a fully executed copy of the Mortgage by the Mortgagor;

(b) delivery of a certificate of residence of the trustee;

(c) delivery of an affidavit of good faith; or

(d) delivery of an affidavit of consideration or specification of consideration in the Mortgage?

3. Are there any other special requirements or statutory provisions with respect to the form and contents of the Mortgage which have not been, but should be, incorporated in the present draft?

4. Must the Obligations be stated in a definite dollar amount? If a definite amount is required to be stated, will interest or expenses be required to be included in such amount or can such item be in addition to such definite amount?

5. Does your State require that the Obligations be evidenced by a separate note rather than a loan agreement?

6. Will the Mortgage secure discretionary future advances with the same priority if the loan is a revolving loan or the entire credit is not advanced at one time?

(a) Is there any time or dollar limitation to future advances which are intended to be secured by the Mortgage?

(b) Must the Lender's obligation to make future advances be unconditional?

7. Is the Mortgage in proper form for recording, assuming appropriate execution and acknowledgment?

8. What forms of execution and acknowledgment must be used in your State?

9. Should the Mortgage be filed in any records other than the real property mortgage records and the U.C.C. financing statement records?

10. Is there any requirement for the recording or filing of the Mortgage within a particular period of time after execution?

11. Are there any restrictions under the laws of your State affecting a requirement that the Mortgagor pay all fees and taxes for recording the Mortgage or any other fees associated with the Mortgage, including attorneys' fees and disbursements?

12. Will the Lender be required to do any of the following as a condition precedent to the exercise of its rights as lender, mortgagee or collateral assignee (assuming the Lender's only contact with your State is in such capacity):

(a) qualify to do business in your State as a foreign bank or corporation;

(b) file a designation for service of process;

(c) pay any State taxes; or

(d) appear to defend a legal action in your State which is unrelated to the

Mortgagor's loan transaction with the Lender?

13. Where the Mortgage operates as a deed of trust or trust deed, are there any particular requirements with respect to the trustee, such as whether the trustee must be a resident of or qualify to do business in the State or qualify as a trustee or trust company?

14. Are the following provisions in the Mortgage valid and enforceable:

(a) the right to collect the proceeds of production directly from the purchaser either before or after default but prior to foreclosure or other enforcement action;

(b) mandatory appointment of a receiver;

(c) private sale of the properties after notice of default (as opposed to sale by judicial foreclosure);

(d) waiver of rights to valuation or appraisal;

(e) waiver of redemption rights;

(f) waiver of moratorium rights; and

(g) waiver of trial by jury and counterclaims?

15. Are there any mandatory redemption, appraisal or moratorium provisions under the laws of your State applicable to the Mortgage?

16. May a deficiency judgment be obtained after exercise of a power of sale or judicial sale?

17. Is recourse to security required in your State? If the Lender exercises its rights with respect to some portion of the collateral, will such exercise adversely affect the Lender's rights to exercise its rights later with respect to other collateral, whether such other collateral is real or personal, and whether such other collateral is located within or without your State?

18. Will the Mortgage continue to secure the Obligations in the event of the extension of the maturity date, a change of interest rate or other modification of terms without re-recording or other act or notation? Must the Mortgage be renewed or re-recorded after any definite time period?

19. Will the Mortgage serve as a security agreement under the Uniform Commercial Code in your State or any other applicable law relating to security interests in personalty?

(a) Will a standard form of U.C.C. financing statement suffice?

(b) In what records should the financing statement be filed?

20. Are there any mineral contractors' lien, mechanics' lien or other statutory lien provisions in your State that could result in a lien securing debt for operations, material, labor or service provided to the collateral properties subsequent to the recordation of the Mortgage which lien would have a rank or priority superior to the lien of the Mortgage? If so, would such lien:

(a) encumber the entire leasehold interest in and to the leases to which such service or material was provided, or only encumber the interest of the operator or other person contracting with the lien claimant;

(b) encumber severed production and the proceeds therefrom; and

(c) have a higher rank or priority than the Mortgage without regard to whether the lien claimant had been paid for all material and service provided to the properties prior to the recordation of the Mortgage?

21. May land descriptions be incorporated into the Mortgage by reference to the recording data of oil and gas leases or other instruments previously recorded or must the Mortgage contain a complete description of all oil and gas leases and land covered thereby?

APPENDIX B

Assignment of Production

1. *Assignment.* In addition to the conveyance to the Trustee herein made, Mortgagor does hereby transfer, assign, deliver and convey unto Mortgagee, its successors and assigns, all of the oil, gas, and other minerals produced, saved, or sold from the Mortgaged Property and attributable to the interest of Mortgagor therein subsequent to 7:00 a.m. on the first day of the month in which this Deed of Trust is executed, together with the proceeds of any sale thereof. Notwithstanding such transfer, assignment, delivery and conveyance, any purchaser now or hereafter taking production from the Mortgaged Property shall pay to Mortgagor such proceeds derived from the sale thereof and continue making such payments directly to Mortgagor until notified in writing by Mortgagee to commence making such payments directly to Mortgagee, whereupon such purchaser shall thereafter make payments directly to Mortgagee until notified in writing by Mortgagee to discontinue the same. When such payments are required to be made by such purchaser to Mortgagee hereunder, such purchaser of any such production shall not be required to see to the application of the proceeds thereof by Mortgagee, and payment made to Mortgagee shall be binding and conclusive as between such purchaser and Mortgagor.

2. *Change of Purchaser.* Should any purchaser taking the production from the Mortgaged Property fail to make prompt payment to Mortgagee in accordance with the provisions of paragraph 1 above, Mortgagee shall have the right, at the expense of Mortgagor, to demand a change of connection and to designate another purchaser with whom a new connection may be made, without any liability on the part of Mortgagee in making such selection, so long as ordinary care is used in the making thereof. Promptly upon such demand, Mortgagor shall take all necessary and appropriate action to effect such change of connection.

3. *Application of Proceeds.* Mortgagor authorizes and empowers Mortgagee to receive, hold, and collect all sums of money paid to Mortgagee in accordance with the provisions of paragraph 1 above, and to apply the same as hereinafter provided, all without any liability or responsibility on the part of Mortgagee, save and except as to good faith in so receiving and applying such sums. Mortgagee may apply all sums received by Mortgagee pursuant to paragraph 1 above to the payment of the Indebtedness, application to be made in such manner as Mortgagee may elect, regardless of whether the application so made shall exceed the payments of principal and interest then due as provided in the Loan Documents. After such application has been so made by Mortgagee, the balance of any such sums shall be paid to Mortgagor.

4. *No Postponement of Installments on Indebtedness.* It is understood and agreed that should such payments provided for by paragraph 1 above be less than the sum or sums then due on the Indebtedness, such sum or sums then due shall nevertheless be paid by Mortgagor in accordance with the provisions of the Loan Documents, and neither the assignment made pursuant to paragraph 1 above nor any other provisions hereof shall in any manner be construed to affect the terms and provisions of the Loan

Documents. Likewise, neither the assignment made pursuant to paragraph 1 above, nor any other provisions hereof shall in any manner be construed to affect the Liens, rights, title and remedies herein granted securing the Indebtedness or the liability of Mortgagor therefor. The rights under *[this article]* are cumulative of all other rights, remedies, and powers granted under this Deed of Trust and are cumulative of any other security which Mortgagee now holds or may hereafter hold to secure the payment of the Indebtedness.

5. *Turnover to Mortgagee.* Should Mortgagor receive any of the proceeds of any sale of oil, gas, or other minerals produced, saved, or sold from the Mortgaged Property, which under the terms hereof should have been remitted to Mortgagee, Mortgagor will immediately remit same in full to Mortgagee.

6. *Release of Proceeds Upon Payment of Indebtedness.* Upon payment in full of all Indebtedness and the termination of the Commitment, the remainder of such proceeds held by Mortgagee, if any, shall be paid over to Mortgagor upon demand, and a release of the interest hereby assigned will be made, without recourse or warranty, by Mortgagee to Mortgagor at its request and its expense.

7. *Duty of Mortgagee.* Mortgagee shall not be liable for any failure to collect, or for any failure to exercise diligence in collecting, any funds assigned hereunder. Mortgagee shall be accountable only for funds actually received.

8. *Power of Attorney to Mortgagee.* Mortgagor does hereby designate Mortgagee as the agent of Mortgagor to act in the name, place, and stead of Mortgagor for the purpose of taking any and all actions deemed by Mortgagee necessary for the realization by Mortgagee of the benefits of the assignment of production provided herein, recognizing such agency in favor of Mortgagee to be coupled with the interests of Mortgagee under this Deed of Trust and, thus, irrevocable so long as this Deed of Trust is in force and effect.

APPENDIX C

Collateral Account

In order to secure further the performance by Borrower of the Obligation and to effect and facilitate Bank's right of offset, Borrower shall execute such forms, authorizations, documents and instruments, and do such other things, as Bank shall request, in order to require that pipeline companies, operators of the Mortgaged Properties and others (collectively, the "Purchasers") purchasing (or acting as agents for, or making payments on behalf of, those purchasing) the oil, gas and other minerals produced or to be produced from, or relating to, the Borrower's Mineral Interests deliver to a post office box number specified by Bank all royalties, production payments, checks, cash, proceeds and monies now or hereafter payable by the Purchasers (or any of them) on account of oil, gas or other minerals produced from or relating to the Borrower's Mineral Interests or otherwise with respect to the Borrower's Mineral Interests. Borrower further agrees that all such royalties, payments and monies delivered to such post office box shall be deposited by Bank in a cash collateral account at Bank styled "_____ Production Account." Borrower shall, upon receipt, deposit in the _____ Production Account all such royalties, payments and monies which Borrower receives directly from the Purchasers. Borrower hereby irrevocably authorizes and directs Bank to charge from time to time the _____ Production Account and any other accounts of Borrower at Bank for amounts due to the Bank hereunder and under the Notes. Bank is hereby authorized, in its own name or the name of the Borrower, at any time, to notify any or all parties obligated to Borrower with respect to the Borrower's Mineral Interests to make all payments due or to become due thereon directly to the Bank, or such other person or officer as Bank may require whereupon the power and authority of the Borrower to collect the same in the ordinary course of its business shall be deemed to be immediately revoked and terminated. With or without such general notification, Bank may take or bring in Borrower's name or that of the Bank all steps, actions, suits or proceedings deemed by the Bank necessary or desirable to effect possession or collection of payments, may complete any contract or agreement of the Borrower in any way related to any of the Borrower's Mineral Interests, may make allowances or adjustments related to the Borrower's Mineral Interests, may compromise any claims related to the Borrower's Mineral Interests or may issue credit in its own name or the name of the Borrower. Regardless of any provision hereof, however, Bank shall never be liable for its failure to collect or for its failure to exercise diligence in the collection, possession, or any transaction concerning, all or part of the Borrower's Mineral Interests or sums due or paid thereon, nor shall it or they be under any obligation whatsoever to anyone by virtue of its security interests and liens relating to the Mortgaged Properties.

Issuance by the Bank of a receipt to any Person obligated to pay any amounts to Borrower shall be a full and complete release, discharge and acquittance to such Person to the extent of any amount so paid to the Bank. The Bank is hereby authorized and empowered on behalf of the Borrower to endorse the name of the Borrower upon any check, draft, instrument, receipt, instruction or other document of

items, including but not limited to, all items evidencing payment upon any indebtedness of any Person to the Borrower coming into the Bank's possession, and to receive and apply the proceeds therefrom in accordance with the terms hereof. The Bank is hereby granted an irrevocable Power of Attorney, which is coupled with an interest, to execute all checks, drafts, receipts, instruments, instructions or other documents, agreements or items on behalf of the Borrower, either before or after demand of payment on the Notes, as shall be deemed by the Bank to be necessary or advisable, in the sole discretion of the Bank, to protect its security interests and liens in the Borrower's Mineral Interests or the repayment of the Obligation, and the Bank shall not incur any liability in connection with or arising from its exercise of such Power of Attorney.

The application by Bank of such funds shall, unless Bank shall agree otherwise in writing, be first to the payment of costs and expenses due Bank under this Loan Agreement, second to the payment of accrued interest due on a Note and last to the payment of the principal of such Note. Borrower acknowledges that all funds so transferred into the _____ Production Account shall be the property of Borrower only and not subject to any claim by any party other than Bank.

APPENDIX D

Standard Foreclosure Checklist

1. *Title.*
 - (a) Order abstractor's certificate, including written evidence of ad valorem and federal tax lien search.
 - (b) Determine from title work:
 - (i) Who owns the note and mortgage and whether any transfers are required;
 - (ii) Other liens on property. Verify which liens will remain outstanding and which liens will be terminated by foreclosure; and
 - (iii) Whether foreclosure will trigger due-on-sale provisions in prior mortgages.
2. *Governmental Liens.* If there are IRS liens on the property at least 30 days prior to the foreclosure date, notice of the sale must be sent to the IRS in care of the local district director at least 25 days prior to foreclosure sale.
3. *Loan Documents.* Review the loan documents and obtain necessary information from lender personnel in order to:
 - (a) Ascertain what amounts, if any, have been paid by the borrower on the loan other than those amounts called for in the note;
 - (b) Determine prior to sending *any* notices that neither the loan documents, nor other past charges made, could cause violation of applicable usury laws;
 - (c) Determine all dates and notices required under the loan documents for default and acceleration;
 - (d) Determine whether other collateral is available which must be repossessed by some method other than real estate foreclosure;
 - (e) Determine whether the debtor or any guarantors have personal liability for debt;
 - (f) Determine whether the lienholder desires a deficiency judgment against debtor and/or guarantors;
 - (g) Ascertain current fair market value of property by current reserve reports/appraisal; and
 - (h) Analyze bidding parameters in light of fraudulent transfer concerns and rules relevant to maintaining a deficiency.
4. *State Law Notice Compliance.*
5. *State Law Sale Compliance.*