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REPORT



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Upstream Producers Affected by Appeals Ruling: Third Circuit Holds That State-Specific Protections in Favor of Oil and Gas Producers Did Not Apply Under Article 9 of the UCC

*By Mark Tibberts, Natalie L. Regoli, and John F. Lawlor**

In In re SemCrude L.P., the U.S. Court of Appeals for the Third Circuit examined certain state-specific protections in favor of oil and gas producers in Kansas, Oklahoma, and Texas. The court held that the application of the choice of law rules in Article 9 of the Uniform Commercial Code meant that the Kansas and Texas protections did not apply with respect to claimed security interests in property of SemCrude. The court also held that the Oklahoma protection, which was effected outside of that state's UCC, was not applicable to downstream oil purchasers. The authors of this article explain the state-specific producer protections and the court's decision.

The U.S. Court of Appeals for the Third Circuit issued an opinion, *In re SemCrude L.P.*,¹ which examined certain state-specific protections in favor of oil and gas producers in Kansas, Oklahoma, and Texas. The court held that the application of the choice of law rules in Article 9 of the Uniform Commercial Code (“UCC”) meant that the Kansas and Texas protections (which were effected by means of nonuniform amendments to such states’ UCCs) did not apply with respect to claimed security interests in property of SemCrude, a Delaware limited partnership. The court also held that the Oklahoma protection, which was effected outside of that state’s UCC, was not applicable to downstream oil purchasers.

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¹ Nos. 15-3094, 15-3095, 15-3096 & 15-3097.

BACKGROUND

SemGroup L.P. and its subsidiaries (“SemGroup”) are midstream oil and gas service providers, and filed Chapter 11 cases in 2008. SemGroup emerged from bankruptcy in 2009, but litigation related to certain aspects of the bankruptcy has continued since that time.

Two SemGroup companies, SemCrude and Eaglwing, L.P., purchased oil from oil producers, and then sold the oil to downstream purchasers, including to several large oil distributors. Following SemGroup’s bankruptcy filing, the bankruptcy court was inundated with adversary proceedings brought by producers, purchasers and lenders concerning the distribution of SemGroup’s assets.

Various oil producers asserted liens and other protections in oil purchased by SemGroup from them on credit for which the oil producers had not been paid.

STATE-SPECIFIC PRODUCER PROTECTIONS

Kansas, Oklahoma, and Texas are among several states that have enacted statutory liens or other protections for owners of interests in oil and gas to secure the payment of the purchase price to such interest owners.

Kansas and Texas: Nonuniform UCC Provisions

Kansas and Texas have adopted similar nonuniform amendments to Article 9 of their UCCs to provide “interest owners”² a security interest “to secure the obligations of the first purchaser of oil and gas production, as debtor, to pay the purchase price.”³ Under the UCC of each of these states, the owners of oil and gas interests are given the equivalent of a purchase money security interest in oil produced and sold to the “first purchaser.”⁴ In Texas, such security interest is automatically perfected, without the need to file a UCC financing statement.⁵ In Kansas, if the interest owner files an affidavit of production, such filing is

² Defined to include any “person owning an entire or fractional interest of any kind or nature in oil or gas production at the time of severance, or a person who has an express, implied, or constructive right to receive a monetary payment determined by the value of oil or gas production or by the amount of production.” Tex. Bus. & Com. Code § 9.343(r)(2); Kan. Stat. § 84-9-339a(p)(2).

³ See Tex. Bus. & Com. Code § 9.343; Kan. Stat. § 84-9-339a.

⁴ Defined as “the first person that purchases oil or gas production from an operator or interest owner after the production is severed, or an operator that received production proceeds from a third-party purchaser who acts in good faith under a division order or other agreement signed by the operator under which the operator collects proceeds of production on behalf of other interest owners.” Tex. Bus. & Com. Code § 9.343(r)(3); Kan. Stat. § 84-9-339a(p)(3).

⁵ Tex. Bus. & Com. Code §§ 9.310(b)(11), 9.343(b).

effective as a financing statement covering as-extracted collateral.⁶ Under the UCC of each of these states, a writing giving the interest owner a right under real property law operates as an Article 9 security agreement, and the act of the first purchaser in signing an agreement to purchase oil or gas production or in making any other voluntary communication to the interest owner or any governmental agency recognizing the interest owner's right operates as an authentication of the security agreement.⁷ Under the terms of these nonuniform provisions, such security interests are given express priority over the interests of purchasers that are not buyers in the ordinary course of business,⁸ and are treated as purchase money security interests.⁹

Oklahoma

Section 570.10.A of Oklahoma's Production Revenue Standards Act¹⁰ (the "PRSA") provides that all proceeds from the sale of oil or gas production shall be regarded as separate and distinct from all other funds of any person receiving or holding the same, until such time as the proceeds are paid to the owners legally entitled thereto, and that the proceeds are to be held for the benefit of such interest owners, but that no express trust is created.¹¹

THE BANKRUPTCY COURT AND DISTRICT COURT DECISIONS

In the underlying adversary litigation, the downstream purchasers moved for summary judgment on the grounds that (i) they took free of the producers' security interests under UCC § 9-317(b), (ii) they took free of the producers' security interests as buyers in the ordinary course of business of goods under UCC § 9-320(a) and (iii) the PRSA did not create a constructive trust over oil sold to SemGroup by Oklahoma based producers.¹² The producers had relied

⁶ Kan. Stat. § 84-9-339a(b). There is no requirement in Kansas of refileing such an affidavit every five years to continue the perfection of the security interest, unlike the law applicable to many financing statements under UCC § 9-515(a). *Id.*

⁷ Tex. Bus. & Com. Code § 9.343(a); Kan. Stat. § 84-9-339a(a).

⁸ Defined in UCC § 1-201(b)(9).

⁹ Tex. Bus. & Com. Code § 9.343(e), (f); Kan. Stat. § 84-9-339a(e), (f).

¹⁰ 52 Okla. Stat. § 570.1 *et seq.*

¹¹ Since the *SemCrude* bankruptcy, and in response to the same, Oklahoma has adopted a new statute to protect interest owners, The Oil and Gas Owners' Lien Act of 2010, 52 Okla. Stat. § 549.1 *et seq.* Such statute revised a prior statute that granted lien rights to oil and gas producers. *See, e.g.,* Miller and Harrell, *Aftermath of the SemGroup Case: Oklahoma Enacts the Oil and Gas Owners' Lien Act of 2010*, Oklahoma B. J., Dec. 11, 2010, Vol. 81, No. 33.

¹² After the bankruptcy court issued its decision, but before the district court issued its decision, the Oklahoma Court of Appeals issued an opinion directly dealing with the issue of whether the PRSA created a constructive trust. *Gaskins v. Texon, L.P.*, 321 P. 3d 985 (Okla. Civ.

on the automatic perfection provided by the Kansas and Texas nonuniform UCC provisions, and had not filed financing statements against SemGroup to perfect their security interests.

The bankruptcy court filed proposed findings of fact and conclusions of law recommending for summary judgment in favor of the downstream purchasers. The district court adopted such recommendations.¹³

THE THIRD CIRCUIT DECISION

The Third Circuit affirmed the bankruptcy court and district court rulings.

A critical element of the rulings below was the courts' analysis of the choice of law rules in Article 9 of the UCC and the application of those rules to SemGroup.

UCC § 9-301(1) provides that, subject to certain exceptions, "while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral."¹⁴ The SemGroup entities that purchased the oil from the producers were "registered organizations"¹⁵ for UCC purposes, and "located" for purposes of UCC § 9-307(e) in Delaware and Oklahoma. The versions of the UCC in effect in Delaware and Oklahoma did not include the automatic perfection provisions for producer security interests in effect under the UCCs of Kansas and Texas. Because the producers did not file UCC financing statements against SemGroup to perfect their security interests, the Third Circuit agreed with the courts below that the producers' security interests were unperfected.

The Third Circuit considered a separate argument that the UCC choice of law rule in UCC § 9-301(4) should apply instead of the rule in UCC

App. 2014). The court in *Gaskins* held that "nothing in the language of 570.10(A) creates or suggests a duty on a downstream purchaser or applies to downstream purchasers of oil and gas after it reaches the stream of interstate commerce. Moreover, there is nothing in that language requiring the imposition of an implied trust." The district court and the Third Circuit each referred to *Gaskins* on this issue.

¹³ See *In re: SemCrude, L.P.*, 504 B.R. 39, 2013 Bankr. LEXIS 3250 (Bankr. D. Del. 2013); *In re: SemCrude, L.P.*, 2015 U.S. Dist. LEXIS 99453 (D. Del. 2015). The bankruptcy court had issued two other opinions construing the Kansas, Oklahoma and Texas statutes, *Mull Drilling Co., Inc. v. SemCrude, L.P.*, 407 B.R. 82, 2009 Bankr. LEXIS 1405 (Bankr. D. Del. 2009), and *Arrow Oil & Gas, Inc. v. SemCrude, L.P.*, 407 B.R. 112, 2009 Bankr. LEXIS 1403 (Bankr. D. Del. 2009).

¹⁴ Each of Delaware, Kansas, Oklahoma, and Texas had adopted the uniform version of UCC § 9-301.

¹⁵ Defined in UCC § 9-102(a)(71).

§ 9-301(1). UCC § 9-301(4) provides that the “local law of the jurisdiction in which the wellhead or minehead is located governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in as-extracted collateral.” The court concluded that the producers’ oil did not qualify for this exception because, in order for the oil to constitute “as-extracted collateral” under UCC § 9-102(a)(6), the debtor had to have an interest in the oil before it was extracted. SemGroup had no such interest.

Under UCC § 9-317(b), a buyer of goods takes free of a security interest if the buyer gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected. The Third Circuit agreed with the courts below that the downstream purchasers qualified as buyers for value of the oil from SemGroup, since the producers’ security interests were not perfected. For purposes of the UCC, “knowledge” is defined to mean actual knowledge,¹⁶ and there was no evidence that the purchasers had actual knowledge of the producers’ liens. The Third Circuit also held that the purchasers acquired the oil from SemGroup for value.¹⁷

The courts below also found that the downstream purchasers took free of the producers’ security interests as buyers in the ordinary course of business under UCC § 9-320(a).¹⁸ Unlike the case under UCC § 9-317(b), a buyer in the ordinary course of business will take free of a perfected security interest in goods even if the buyer knows of its existence. The Third Circuit did not consider this argument, and only analyzed UCC § 9-317.

The Third Circuit also held that the PRSA did not create an implied trust on the oil in the hands of the downstream purchasers, and that the PRSA did not apply to the downstream purchasers.

¹⁶ UCC § 1-202(b).

¹⁷ UCC § 1-204.

¹⁸ “Buyer in the ordinary course of business” is defined in UCC § 1-201(b)(9).