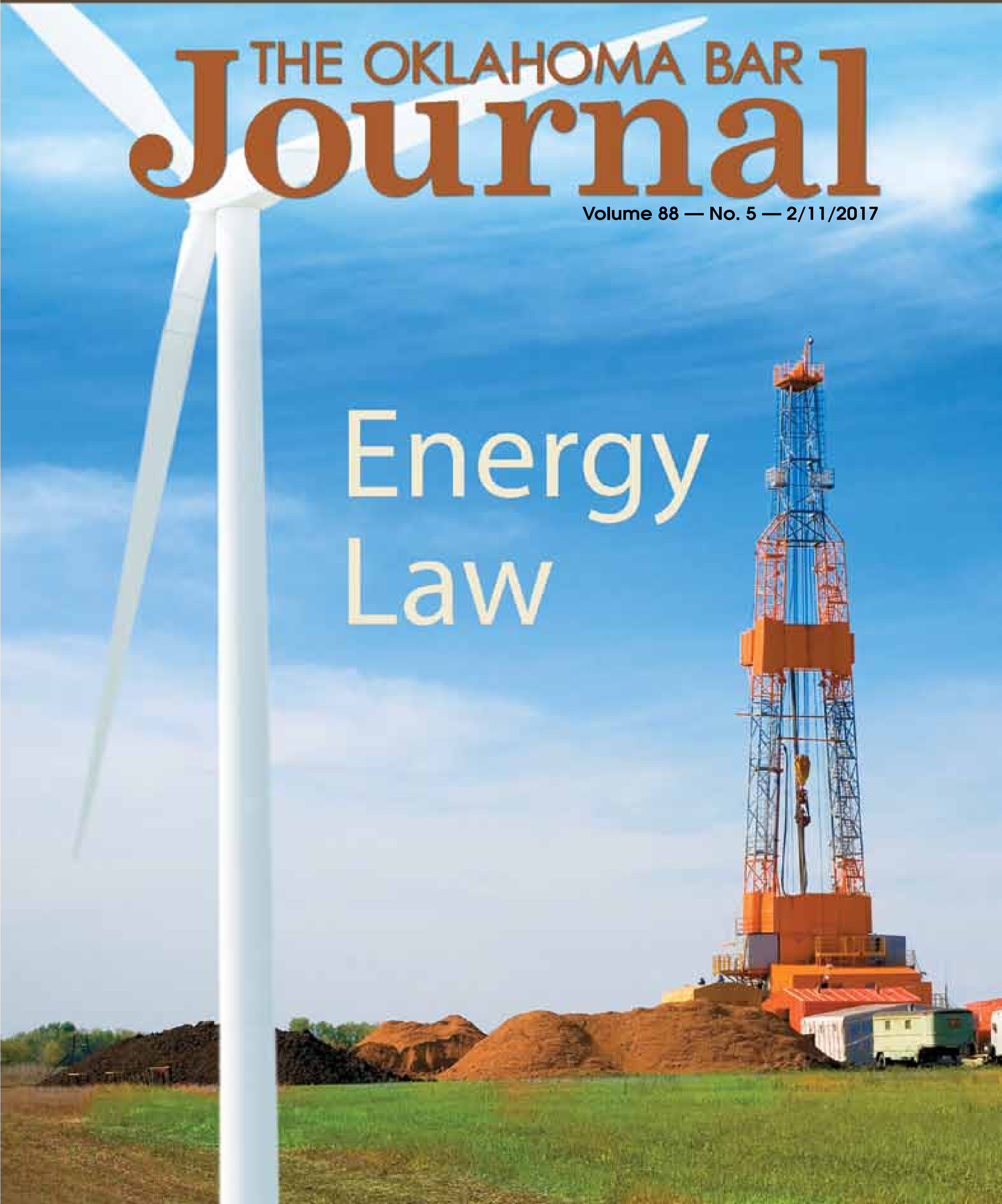
ALSO INSIDE: OBA Day at the Capitol
Legislative Monitoring Committee Report

THE OKLAHOMA BAR Journal

Volume 88 — No. 5 — 2/11/2017

Energy Law



Don't Forget About Us

Considerations for Nonoperating Interest Owners During Down Economic Periods in Oklahoma's Oil and Gas Industry

By W. Jason Hartwig

When Oklahoma's oil and gas industry hit its most recent downturn and oil prices began to fall, the impact on the state's oil and gas exploration and production companies was naturally the first matter for examination. It is easy to forget the other interest owners who are directly impacted by the same economic factors. Nonoperating interest owners, such as working interest owners and royalty owners, are akin to silent partners in a business in that they are not normally involved in the day-to-day drilling and production operations. These interest owners invest money in well operations and/or their leasehold interests hoping for a return or additional income realized from a once unproductive interest in land. Working interest owners and royalty owners rely on their well operators to accomplish these goals. As a result, these nonoperating interest owners will not only feel the pinch from the fallout of the waning market but also the accompanying actions of their well operators.

This article focuses on the position of these nonoperating interest owners under a couple of typical scenarios. First, the scope of liability and the practical courses of action for a working interest owner when a well operator stops paying invoices to third-party service providers and vendors and the leasehold becomes subject to a statutory oil and gas well lien. Second, the interests of nonoperating interest owners when their well operator files for bankruptcy.

NONOPERATING OWNERS AND STATUTORY OIL AND GAS WELL LIENS

A working interest owner who is current on his joint interest billing statements suddenly receives a notice of a lien against a well in which he has invested. The working interest owner reads over the notice and does not recognize the name of the lien claimant, a third party that has provided some service at the well site for the last year. The notice specifically names the working interest owner as a debtor and subjects his leasehold interest to the lien. After making a few phone calls, the working interest owner comes to realize the well operator has not been paying the invoices for services and materials provided by third parties.

Unfortunately, this is an all too common scenario for working interest owners. During lean economic times in the oil and gas industry, laborers and vendors providing services and materials to a drill site are more likely to forego future business relationships and seek compensation for unpaid invoices by way of filing statutory oil and gas liens. Oil and gas well liens pursuant to 42 Okla. Stat. §144 operate to protect laborers and vendors who provide labor or services or furnish materials or supplies for oil and gas operations.[1] Section 144 requires the lien claimant perform services "under contract, expressed or implied, with the owner of any leasehold for oil and gas purposes . . . "[2] Most often, the lien claimant will have contracted with the operator of the well and this privity of contract will form the basis for naming the operator as debtor in the requisite statutory lien statement. Under §144, parties in privity of contract with the lien claimant may be held personally liable for the debts secured by the oil and gas well lien.[3] Thus, the contracting operator named in the lien statement can be held personally liable for the debt secured by the lien.

Lien claimants have no validly perfected lien against working interest owners who are not, at a minimum, named in the lien statement.[4] Nonoperating working interest owners may be held jointly and severally liable for the debt secured by a §144 lien if there is privity of contract between the interest owner and the lien claimant, a court finds the existence of a mining partnership or joint venture among the operator and other working interest owners[5] or the operator contracts with the lien claimant acting as agent for the nonoperating working interest owners.[6]

In the absence of a mining partnership, a joint venture or an agency relationship, the liability of the passive, nonoperating working interest owner is merely several liability.[7] The Oklahoma Supreme Court's early rulings addressing the liability of working interest owners upheld the principle that no personal judgment can be obtained in the absence of contractual privity and that liability of those working interest owners named in the lien statement would only extend to their respective leasehold interests.[8]

The nature of the working interest owner's several liability has only recently come into question regarding whether it is limited to the interest owner's leasehold interest and/or personal liability for his proportionate share of the debt. Nearly seven decades after the Oklahoma Supreme Court established the parameters for working interest owner liability subject to an oil and gas well lien, the court issued a curious opinion in *K&H Well Service, Inc. v. Tcina, Inc.*,[9] which may have opened the door to allow for personal, several liability up to each working interest owner's interest in the leasehold that is subject to the lien.

In *K&H*, the Oklahoma Supreme Court addressed the liability of a contract operator and a 5 percent working interest owner for unpaid reworking and drilling services that subjected the well sites to §144 liens.[10] With respect to the contract operator, the court affirmed the trial court's determination that the operator cannot be liable for the debts secured by the liens, because the operator owned no working interest in the wells and contracted with the lien claimant as an agent for disclosed principals (*i.e.*, the working interest owners).[11] The court did hold the 5 percent working interest owner liable and ruled the lien claimant could foreclose against the 5 percent leasehold interest, because the operator contracted with the lien claimant while acting as agent for the working interests.[12] The court further ruled "[u]pon remand *unless a mining partnership is found to exist* between Tcina Holding Co., Ltd. and the other record leasehold owners, Tcina Holding Co., Ltd. can only be found liable for five percent (5%) of the contracted for charges."[13] Thus, in addition to allowing lien claimant to foreclose working interest owner's leasehold interest, the court also granted the lien claimant a money judgment against to the extent of working interest owner's 5 percent interest even in the absence of a mining partnership.[14] In a footnote, the court reveals the basis for this ruling is its reliance upon its earlier decision in *Sparks Brothers Drilling Co. v. Texas Moran Exploration Co.*:[15]

> Appellee misreads *Sparks* when it asserts that it holds when no mining partnership is found to exist, each participant's liability for a well's drilling costs is *in rem* only. *Sparks* holds that each participant's liability — when no mining partnership exists — is limited to that quantum of interest [here 5%] which each participant possesses in the well, *i.e.*, each participant is *severally* liable for expenses in direct proportion to the quantum of leasehold-interest owned. The obligation is not just *in rem* but rather is both *in rem* and *in personam*.[16]

In *Sparks Brothers*, the Oklahoma Supreme Court addressed the issue of whether a 25 percent working interest owner in a well should be held joint and severally liable for services and materials furnished in the completion of the well.[17] In reversing the lower court's ruling, the court held that a nonoperating working interest owner under a joint operating agreement that expressly stated it did not create a mining partnership was liable only to the extent of its interest in the leasehold for debts that the operator failed to pay.[18] At the beginning of the court's opinion, it states "[i]f there is not a mining partnership, then [the working interest owner] is severally liable, that is *liable only to the extent of its interest in the well*."[19] The court, however, did not expand on the nature of this liability and whether it extended only to the working interest owner's leasehold interest or subjected the working interest owner to personal liability to the extent of his interest.[20]

Although it would appear the *K&H* case would allow lien claimants to both foreclose on a working interest owner's leasehold interest and hold him personally liable to the extent of his interest, the opinion could be relegated to the specific facts of the case for several reasons. The *K&H* court relies upon the *Sparks Brothers* decision, but the *Sparks Brothers* opinion does not indicate that the several liability of a passive working interest owner necessarily includes *in personam* and *in rem* liability. The *K&H* opinion would contradict longstanding Oklahoma Supreme Court precedent regarding the liability of working interest owners, even though the court did not specifically overrule or even address any of its past decisions. Most importantly, the *K&H* court specifically found the presence of an agency relationship between contract operator and the working interest owners with respect to operator's act of contracting with the lien claimant. The underlying facts of the *K&H* case create some natural limitations on its future application and may be interpreted with respect to its ruling regarding the personal liability of working interest owners to apply in those cases involving an agency relationship between the contracting party (agent) and the other working interest owners (disclosed principals). Thus, while the *K&H* case creates some question regarding the nature of this liability as *in rem* and/or *in personam* liability, the liability of passive, nonoperating working interest owners should be regarded as several liability with respect to their leasehold interests thereby allowing lien claimants to foreclose on the working interest owners' percentage interest in the lease.

Assuming the validity of the lien, working interest owners are left with very few practical options when subjected to a §144 oil and gas well lien. If the working interest owner can afford to concede its working interest in a well or the well has resulted in a dry hole leaving the leasehold value very low, the working interest owner can allow the lien claimant to foreclose on the working interest owner's leasehold interest and he will no longer own that interest. However, there may be circumstances where the working interest owner would wish to retain his interest in a well for any number of reasons such as the presence of a profitable well on the leasehold or the working interest owner's interest is subject to financing. In this case, a lengthy search of Oklahoma case law has yet to reveal a case addressing whether a working interest owner may retain his proportionate share of the leasehold estate subject to an oil and gas well lien by paying his proportionate share of the debt to the lien claimant. From a practical perspective, a working interest owner should be permitted to pay his share of the debt and retain his leasehold interest. This may be accomplished initially without judicial intervention. The lien claimant can be approached, the working interest owner can pay his share of the debt, and the lien claimant can release the working interest owner from the lien. This release should preclude the lien claimant from later seeking to foreclose the working interest owner's share of the leasehold estate.

If a court allowed the working interest owner to pay his share of the debt, the concept of double recovery should preclude the lien claimant from subsequently seeking to foreclose the working interest owner's leasehold interest. In other words, if the working interest owner is only *in rem* severally liable, the lien claimant could not recover both the working interest owner's proportionate payment of the debt and foreclose on the working interest owner's portion of the leasehold estate. Nevertheless, where the working interest owner has paid its share of the costs to its operator and the operator fails to pay third-party laborers or vendors, working interest owners may find themselves in the unfortunate position of having to double pay their proportionate share of fees for labor or materials directly to a lien claimant as well in order to have the lien removed from the leasehold estate.

NONOPERATING OWNERS AND OKLAHOMA'S OIL AND GAS OWNERS' LIEN ACT OF 2010

When a well operator files for bankruptcy, the nonoperating interest owners are not without recourse. Prior to 2010, working interest owners and royalty owners were particularly vulnerable when their operator filed for bankruptcy with respect to oil and gas production and production proceeds from a well. The Delaware bankruptcy companion cases in *In re SemCrude, L.P.*[21] (*SemCrude* litigation), marked a necessary turning point for the status of royalty owners and working interest owners alike in bankruptcy with respect to their interests in produced oil and gas and the sales proceeds.

SemGroup LP and its affiliates (SemCrude, SemGas, Eaglwing) were in the business of purchasing, marketing and distributing oil and gas extracted from oil and gas wells in at least eight different states including Oklahoma. In 2008, SemGroup affiliates and a large number of Oklahoma producers entered into agreements for the purchase and sale of oil and gas from Oklahoma wells. From June 1 through July 21, 2008, the Oklahoma producers delivered oil and gas to the SemGroup affiliates. SemGroup and its affiliates filed petitions in bankruptcy on July 22, 2008. However, the Oklahoma producers did not receive payment for the oil and gas delivered between June 1, 2008, and the petition date. The Oklahoma producers asserted claims in bankruptcy against SemGroup and its affiliates totaling $127 million which represented the amount of unpaid oil and gas sales proceeds.

The Oklahoma producers' claims were met by competing claims asserted by the lenders of SemGroup and its affiliates. The lenders asserted claims as secured creditors with priority over the claims of the Oklahoma interest owners in the produced oil and gas. These lenders held prepetition security interests properly perfected under Article 9 of the U.C.C. prior to the SemGroup affiliates purchasing the oil and gas from the Oklahoma producers. As a result, the lenders, as secured creditors, demanded any proceeds from produced oil and gas be applied to settle their prepetition security interests prior to the settlement of any claims of the Oklahoma producers and any other Oklahoma interest owners. Thus, in addition to a large number of other issues, the *SemCrude* court was charged with determining the rights, status and relative priority of the interests of the Oklahoma producers in the oil and gas sold to the SemGroup affiliates and the proceeds therefrom.

The Oklahoma producers asserted two primary arguments that they held secured claims with priority over the SemGroup lenders: 1) the Oklahoma Production Revenue Standards Act[22] (PRSA) created an implied trust with respect to production proceeds in favor of the Oklahoma interest owners and 2) the Oklahoma Oil and Gas Owners' Lien Act of 1988[23] (1988 Act) provided the Oklahoma interest owners with a first priority statutory lien. The *SemCrude* court held that the PRSA did not create a trust with respect to production and production proceeds, and the 1988 Act carved out an exception for U.C.C. Article 9 secured creditors, such that working interest owners lost priority to Article 9 secured creditors in oil and gas production. The absence of an implied trust and the lack of a statutory lien with priority over Article 9 secured creditors were two weaknesses with respect to the position of Oklahoma interest owners that led to the passage of the Oklahoma Oil and Gas Owners' Lien Act of 2010[24] (2010 Act).

The 2010 Act grants each interest owner an oil and gas lien to secure the obligations of the first purchaser of production to pay the sales price to the extent of each interest owner's interest in oil and gas sales derived from an incident to the interest owner's oil and gas rights.[25] The basic characteristics of the lien created under the 2010 Act include the following: 1) it continues uninterrupted in oil and gas upon and after severance; 2) it continues uninterrupted in oil and gas production proceeds; 3) it is not dependent on possession of or title to the oil and gas; 4) it is transferred when oil and gas rights are conveyed or transferred, except to the extent any oil and gas rights are retained and 5) it terminates when the sales price is received.[26] In the typical scenario where the first purchaser pays a representative of the interest owners in a well, such as the operator, the interest owners' lien continues uninterrupted in the proceeds in the possession of the representative until the owners are paid in full.[27]

The 2010 Act strengthened the working interest owners' lien under the original 1988 Act in three key areas. First, the 2010 Act affirmatively establishes Oklahoma law shall govern oil and gas transactions with Oklahoma interest owners.[28] One of the critical decisions by the Delaware bankruptcy court during the *SemCrude* litigation was that Delaware law applied to determine whether a security interest was perfected, not the laws of the states where production occurred (*i.e.*, where the states' oil and gas liens may be applied). Since the lien is created incident to ownership of oil and gas rights, the lien created by the 2010 Act is not a U.C.C. Article 9 security interest but rather arises as part of a real estate interest of the interest owner in the minerals.[29] As a result, the applicable law under governing choice of law principles is the law of the state where the well is located.[30] The 2010 Act eliminates the need to follow the law of other states with respect to perfection of liens, particularly the need to file lien or financing statements in the debtor's state of incorporation.

Second, the 2010 Act strengthens the position of Oklahoma interest owners by creating an oil and gas lien that "exists in and attaches immediately to all oil and gas on the effective date of the [2010 Act]," which is April 19, 2010, and "continues uninterrupted and without lapse in all oil and gas upon and after severance . . . and to all proceeds."[31] In other words, an Oklahoma interest owner essentially receives an automatic lien in his proportionate share of the oil and gas production and any subsequent sales proceeds until he receives his share of the proceeds from production.[32] Furthermore, the "oil and gas lien is granted and exists as part of an incident to the ownership of oil and gas rights and is perfected automatically without the need to file a financing statement or any other type of documentation."[33] The nature of the lien provided for under the 2010 Act is truly automatic by omitting the need for filing any statement of the lien for the purposes of perfection.

> **"...the 2010 Act creates a super-priority, automatic lien in oil and gas production and production proceeds for all Oklahoma interest owners."**

Third, the 2010 Act expressly provides for super-priority over all other lienholders and secured creditors. "Except for a permitted lien, an oil and gas lien [created under the 2010 Act] is a lien that takes priority over any other lien, whether arising by contract, law, equity or otherwise, or any security interest."[34] A permitted lien is essentially a mortgage or security interest granted by a first purchaser which "secures payment under a written instrument of indebtedness signed by the first purchaser."[35] The "instrument of indebtedness" securing a permitted lien must have been accepted prior to the effective date of the 2010 Act, with a fixed amount of principal and maturity date.[36] Thus, "a permitted lien does not include a mortgage lien or security interest which secures payment of any indebtedness incurred from and after the effective date of [the 2010 Act] . . . "[37]

In sum, although production and any sales proceeds may not be held in trust by a producer on behalf of the other interest owners, the 2010 Act creates a super-priority, automatic lien in oil and gas production and production proceeds for all Oklahoma interest owners. It is inevitable that litigation will arise testing the super-priority of the automatic lien created by the 2010 Act against competing oil and gas liens[38] and secured interests. Until such time, the 2010 Act should be interpreted as significantly strengthening the position of Oklahoma interest owners with respect to their rights in oil and gas production and production proceeds.

Working interest owners and royalty owners should be recognized as creditors in their operator's bankruptcy case with prepetition claims resulting from their automatic liens in production and production proceeds pursuant to the 2010 Act. From a practical perspective, it is likely that an operator's bankruptcy estate will not include unsold oil and gas production or a significant amount of undistributed production proceeds. However, at a minimum, the working interest owners and royalty owners should take the opportunity to have their claims acknowledged by filing a proof of claim in bankruptcy. A proof of claim is the written statement filed in a bankruptcy case setting forth a creditor's claim which describes the reason for and amount of the debt allegedly owned by the debtor to the creditor along with the secured status if the claim is secured. A proof of claim must conform substantially to the appropriate official form.[39] The deadline for filing a proof of claim will generally depend on the type of bankruptcy case. In a Chapter 7 liquidation case, only if the case trustee files a Notice of Possible Dividends, then a creditor will be sent a notice of the deadline (bar date) by which a claim is due. The time for filing a proof of claim in a Chapter 7 case is usually set at not later than 90 days after the first date set for the meeting of creditors with a few exceptions.[40] In a Chapter

11 corporate reorganization case, creditors will receive a specific notice of the deadline (bar date) by which a claim is due.[41]

CONCLUSION

As detailed throughout this article, the reality of dismal economic periods in this state's oil and gas industry is that nonoperating interest owners may be left with few options that are largely reactionary courses of conduct which may prove fruitless in retaining leasehold interests or securing undistributed proceeds from production. The legal consequences of a statutory oil and gas well lien, pursuant to 42 Okla. Stat. §144, have the potential to place working interest owners in an inequitable position in order to preserve their leasehold interests. However, the same interest owners have a strengthened position with respect to oil and gas production proceeds as a result of the automatic lien created under the Oil and Gas Owners' Lien Act of 2010. The key to preserving whatever interest the working interest owners and royalty owners may be able to retain is to avoid delay in taking action to preserve their interests and to periodically monitor the operations and financial stability of its operators to the extent possible. With knowledge of the rights and liabilities of working interest owners and royalty owners as detailed herein, these interest owners will be able to act decisively when faced with a statutory lien or the bankruptcy of an operator.

1. *See* 42 Okla. Stat. §144.
2. 42 Okla. Stat. §144.
3. *See* 42 Okla. Stat. §144.
4. *In re Mahan & Rowsey, Inc.,* 27 B.R. 883, 887 (Bankr. W.D. Okla. 1983) ("held that the liens [created under section 144] are not validly perfected against entities whose interests were of record at the time the lien statements were filed by who were not named in them"); *see Forry v. Brophy,* 243 P. 506, 506, 509 (Okla. 1926) (*Syll.* 3) (failure of lien claimants to name the owner of a 1/32 interest in an oil and gas leasehold estate in their lien statements was held fatal to the creation of a statutory lien upon the owner's interest); *Joe Brown Co., Inc. v. Best*, 601 P.2d 755, 757 (Okla. Civ. App. 1979) (lien claimant had no validly perfected lien against wife and joint owner of the property due to failure to name her in the lien statement); *see also* 42 Okla. Stat. §142 (requisite information to be included in lien statement).
5. *Sparks Bros. Drilling Co. v. Texas Moran Exploration Co.*, 829 P.2d 951, 952 (Okla. 1991); *Robinson Petroleum Co. v. Black, Sivalls & Bryson*, 280 P. 593, 596 (Okla. 1929).
6. *See Spartan Petroleum Corp. v. Curt Brown Drilling Co.*, 446 P.2d 808, 813-14 (Okla. 1968); *see also Sparks Bros. Drilling Co. v. Texas Moran Exploration Co.*, 829 P.2d 951, 952 (Okla. 1991); *Oklahoma Co. v. O'Neil,* 440 P.3d 978 (Okla. 1968).
7. *See Sparks Bros. Drilling*, 829 P.2d at 952 ("If there is not a mining partnership, then [the working interest owner] is severally liable, that is liable only to the extent of its interest in the well."); Watts, "Contingent Liability of the Passive Working Interest Investor Under Operating Agreements in Oklahoma," 54 *Okla. B.J.* 2797 (1983) ("If no such relationship exists, each party's liability is several, and judgment may only be enforced against each personally for his pro rata amount of the indebtedness.").
8. *McNally v. Cochran*, 46 P.2d 955, 959 (Okla. 1935); *Conservation Oil Co. v. Graper,* 46 P.2d 441, 444 (Okla. 1935); *Anderson v. Keystone Supply Co.*, 220 P. 605, 608-09 (Okla. 1923). Several liability extending to the leasehold interests of working interest owners stems from the provisions of section 144 which expressly provides that the oil and gas well lien "may attach to or upon said leasehold . . . ." 42 Okla. Stat. §144.
9. *K&H Well Service, Inc. v. Tcina, Inc.*, 51 P.3d 1219 (Okla. 2002)
10. *Id.* at 1221.
11. *Id.* at 1224.
12. *Id.*
13. *Id.* at 1224-25 (emphasis in original).
14. *Id.* at 1225-26.
15. *Sparks Brothers Drilling Co. v. Texas Moran Exploration Co.,* 829 P.2d 951 (Okla. 1991)
16. *Id.* at 1225 n.17 (emphasis in original).
17. *Sparks Brothers Drilling*, 829 P.2d at 952.
18. *Sparks Brothers Drilling*, 829 P.2d at 952, 954.
19. *Sparks Brothers Drilling*, 829 P.2d at 952 (emphasis added).
20. *See Sparks Brothers Drilling*, 829 P.2d at 952.
21. *See In re SemCrude*, *L.P.*, 407 B.R. 140 (Bankr. D. Del. 2009)
22. 52 Okla. Stat. §§570.1 *et seq.*
23. 52 Okla. Stat. §§548 *et seq.*
24. 52 Okla. Stat. §§549.1 *et seq.*
25. 52 Okla. Stat. §549.3; *see* 52 Okla. Stat. §549.2(9)(a) ("oil and gas rights" generally include any right, title or interest, in and to oil and gas or the proceeds therefrom).
26. 52 Okla. Stat. §549.3.
27. 52 Okla. Stat. §549.3(C).
28. 52 Okla. Stat. §549.9.
29. 52 Okla. Stat. §549.3 (Cmt. 2).
30. 52 Okla. Stat. §549.3 (Cmt. 2).
31. 52 Okla. Stat. §549.3.
32. 52 Okla. Stat. §549.3.
33. 52 Okla. Stat. §549.4.
34. 52 Okla. Stat. §549.7.
35. 52 Okla. Stat. §549.2(11).
36. 52 Okla. Stat. §549.2(11)(a).
37. 52 Okla. Stat. §549.2(11)(a)(1).
38. Among other potential conflicts, the 2010 Act's automatic super-priority granted in a lien in oil and gas proceeds directly conflicts with the superior priority afforded liens under 42 Okla. Stat. §144. Section 144 provides a similar lien in oil and gas proceeds that is supposed to be "preferred to all other liens or encumbrances . . . " 42 Okla. Stat. §144. Since the 2010 Act is a later and more specific statutory scheme, it may be assumed that the Oklahoma legislature intended for the 2010 Act to control over all earlier statutes, such as 42 Okla. Stat. § 144. Assuming timing is an issue affecting priority, a §144 oil and gas lien has the potential to come into existence and to be perfected prior to the automatic creation of a lien under the 2010 Act, since a service or materials may be provided prior to severance of oil and gas. This is just one example of a competing lien that was not addressed by the Oklahoma legislature in drafting the 2010 Act.
39. Fed. R. Bankr. P. 3001.
40. Fed. R. Bankr. P. 3002.
41. Fed. R. Bankr. P. 3002.

ABOUT THE AUTHOR

W. Jason Hartwig received a B.A. from OU and his J.D. with highest honors from the OCU School of Law. He is an attorney with the law firm Tisdal & O'Hara PLLC, with offices in Oklahoma City and Clinton. His practice is focused on energy and environmental litigation, *ad valorem* tax litigation, business litigation and class action litigation. He is a member of the Custer County, Oklahoma County and American Bar Associations.