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Creating, Protecting and Foreclosing  
A Secured Position in Oil and Gas

CREATING, PROTECTING, AND FORECLOSING  
A SECURED POSITION IN OIL AND GAS

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I. WHAT IS A "SECURED POSITION?"

A. A Special Type Of Property Interest.

1. An interest created in the obligor's property which an obligee can reach for financial protection in the event the obligor fails to perform their obligations.
2. Gives the obligee the right to possess or sell specified property of the obligor as a remedy for obligor's nonperformance.

B. Importance Of A Secured Position.

1. If properly created, and perfected, a secured creditor can apply the debtor's property toward payment of a debt - all other creditors (junior creditors) only have rights in the property to the extent its value exceeds the amount of the secured creditor's claim.

2. For Example:

A loans B \$100,000 to buy a house. B promises (by written agreement - promissory note) to repay A the \$100,000, plus interest, in equal monthly installments over the next 30 years.

As collateral for the loan, A wants rights in the house B is going to purchase. A wants to ensure that if B quits paying on his loan (or other bills), A can rely on the value of the house, instead of B's moral and legal obligation to repay, as an asset from which all or part of the debt can be repaid.

A will secure B's promise to pay contained in the promissory note by obtaining a separate contract from B, called a mortgage, which specifies A's rights in the house (collateral).

To perfect A's special property interest in B's house, A must follow certain procedures designed to give the public notice of A's interest in B's property.

## II. BASIC PROBLEMS IN CREATING A SECURED POSITION

### A. Governing Law Depends On The Nature Of The Property Subject To The Security Interest.

1. Classification problems abound. See generally D. Pierce, Kansas Oil and Gas Handbook §4.10 (K.B.A. 1986).
2. Real property - Mortgage law applies. K.S.A. §§58-2301 to 58-2336 (1983).
3. Personal property - Article 9 of the Uniform Commercial Code (UCC) applies.
4. Other laws apply to the transaction depending upon the classification of the collateral as real or personal property, or as a special type of interest within the general classification of real or personal. For example:
  - a. Oil and gas lease in Kansas is personal property but statutes, for certain purposes, treat it as a real property interest. E.g., K.S.A. §§58-2221 and 58-2222 (1983) (oil and gas treated as real property for recording purposes).

Special-purpose judicial reclassification - Ingram v. Ingram, 214 Kan. 415, 521 P.2d 254 (1974) (security interest in oil and gas lease treated like a mortgage of real property).

- b. Applicable UCC provisions may depend upon further classification of the personal property interest.

- (1) Is the collateral "equipment" or "inventory?" K.S.A. §84-9-109 (2) and (4) (1983).
    - (2) Is the collateral an "account" or "general intangible?" K.S.A. §84-9-106 (1983).
    - (3) Is the collateral a "fixture?" K.S.A.

B. Governing Law Depends On How The Security Interest Is Created.

1. If created by agreement between the parties - mortgage law, Articles 2 and 9 of the UCC, and general contract law will apply.
2. If created by statute, the terms of the statute will apply. For example:
  - a. Mechanics' lien statutes. K.S.A. §§55-207 to 55-210; 55-212 to 55-215 (1983). K.S.A. §§60-1101 to 60-1110 (1983 and Supp. 1986).
  - b. Judgment lien statutes. K.S.A. 60-2202 (Supp. 1986).

III. THE DEVELOPMENT PROCESS

A. Persons Involved.

1. Landowner.
  - a. Owner of land - if title to oil and gas has not been previously severed from the surface estate.
  - b. If oil and gas has been severed, the owner of the mineral interest in oil and gas must grant the development rights.
2. Lease Promoter.
  - a. Acquires right to develop a block of acreage from the appropriate landowners.
  - b. Usually assigns development rights to the developer.
  - c. Usually retains an economic interest in the rights assigned.
3. Lease Developer.
  - a. May or may not be the same person who initially obtains the right to develop from the landowner.
  - b. In Kansas, development is often done through a "promoted" deal with many (usually up to

32) investors involved.

4. Contractors, Subcontractors, and Suppliers.

- a. Provide services and supplies to develop the lease.
- b. Provide services and supplies to maintain the lease in production.

5. Transporters of Production.

- a. Traditionally, purchaser of production also the transporter.
- b. May have a third party providing gathering, treatment, processing, and compression services. May require delivery and redelivery of the production.
- c. New transportation role emerging for natural gas. See FERC Orders 436 and 451.

6. Purchasers of Production.

- a. Usually the producer will sell production to a third party purchaser at or near the field where produced.
- b. Changes in gas market structure may result in sales by producer directly to an end user.

7. Other Participants.

- a. New interests can be created by parties owning rights in the oil and gas.
  - (1) Assign rights in the property interest.
  - (2) Give third parties a secured position in the property interest.
  - (3) Have third parties obtain a secured position by statute.
- b. New interests can be created by involuntary action. For example, judgment in a divorce or other civil action. Death of an interest owner; probate of an estate.

B. Relationships and Documents Involved.

1. Mineral Deeds.

- a. Concerned with mineral deeds and other documents, such as estate and other property-related court proceedings, which determine ownership of the oil and gas mineral estate.
- b. Problem is to account for all the rights which authorize development of the oil and gas in the tract of land you wish to develop; or in which you wish to obtain a secured position.

## 2. Oil and Gas Leases.

- a. Basic document which is used to grant landowner's oil and gas development rights in the land to the lease promoter.
- b. Under the typical oil and gas lease the landowner (Lessor) retains a right to a cost-free share of oil and gas produced from the land - called a "royalty."

Landowner (Lessor) also retains a reversionary right in the land in the event the oil and gas lease terminates.

- c. Lease promoter (Lessee) obtains the right to develop the property subject to the express and implied terms of the oil and gas lease.

## 3. Assignment of Lease Rights.

- a. Often the lease promoter has no intention of developing the lease. Instead, they plan to obtain leases on a block of acreage and then sell them to persons interested in development or resale.
- b. Lease promoter often retains an interest in the assigned lease.

(1) May be a fractional share of the "working interest" - an undivided share of the right to develop ("work") the lease pursuant to its terms. Also called an "operating interest."

(2) May be a right to a share of production from wells on the lease. No right to work the lease - merely a right to receive a share of production. For example: an overriding royalty,

production payment, or net profits interest. Also called a "nonoperating interest."

4. Development of the Lease - Joint Development.

- a. Lease owner may want to leverage the cost and risk of development by conveying undivided working interests to others willing to participate in development. For example:

A agrees to give B a 50% working interest in the leased land if B will provide 50% of the development costs and assume 50% of the risk of development.

Same situation could arise where 640 acres is required to obtain a full allowable. A owns a lease on the North 320 acres and B owns a lease on the South 320 acres.

- b. To coordinate the development of the leased land, or the drilling unit, the cotenants of the working interest usually enter into an Operating Agreement.

Designates the person responsible for the day-to-day operation of the lease and provides guidelines for sharing development decision-making and for sharing revenues and expenses.

- c. Lease owner may want to entice another developer to drill on the leased land. A Farmout Agreement is often used to authorize another developer to drill on the leased land and acquire rights in the working interest.

All or a portion of the working interest is usually assigned, subject to various reassignment obligations depending upon the success of drilling operations.

Operating Agreement usually required since there is a possibility of joint ownership of the working interest.

5. Development of the Lease - Promoted Development.

- a. Instead of sharing the risk of development with another developer, the lease owner may seek direct financial assistance from investors.



- b. Developer sells undivided working interests in the lease pursuant to a Development Agreement whereby the developer agrees to drill one or more wells on the lease.

Development Agreement is often oral; it should always be written.

Often the Development Agreement is incorporated into an Operating Agreement.

- c. Developer may retain an operating or nonoperating interest in the lease, or both. The deal is said to be "promoted" because the developer will generally make money from the sale of interests even though the well is a dry hole. For example:

A owns a lease. The lease cost A \$1,000. A enters into a contract with Drilling Company which agrees to drill a well to a specified depth for \$100,000. Other costs associated with development will require \$9,000. A sells an undivided 1/32nd of the lease to each of 32 investors for \$5,000 per 1/32nd. A's promotion fee is \$50,000.

A may also retain a nonoperating interest in the lease, such as an overriding royalty. A may retain part of the working interest and use some of the promotion fee to pay the share of development costs allocated to his share of the working interest.

- d. Investors will usually enter into an Operating Agreement either with the promoter or someone hired by the promoter to operate the well.

## 6. Contracts for Services and Supplies.

- a. Major contractor - drilling company. Rights of parties specified by the Drilling Contract.
- b. Other service contracts. Developer and drilling company will each contract with various persons to drill, complete, test, equip, and operate wells on the leased land.
- c. Supply contracts. Developer and drilling company will each contract with various persons to provide supplies needed to drill,

complete, test, equip, and operate wells on the leased land.

7. Transportation Agreements.

- a. Transportation agreement may be required where production will be sold at a point off of the lease.
- b. Transporter may provide a number of services in addition to transportation - treatment, processing, storage.

8. Treatment and Processing Agreements.

- a. Production from the well may be delivered to other persons to treat or process production.
- b. In some instances title to production will pass subject to redelivery to the developer. For example, developer may sell gas at the well subject to an obligation to redeliver the gas to developer so liquid hydrocarbons can be removed through processing.

9. Production Purchase Contracts.

- a. Most oil and gas sales occur in the field where they are produced. Title passes to the purchaser in or near the field.
- b. Gas is beginning to be sold at points far removed from the field where produced. Likely to have more direct sales by the producer to the end user.

C. Assets Involved.

1. The development process creates two basic types of assets which can be used to secure an obligation:

- a. Intangible property interests. Contractual rights under the various agreements. For example:
  - (1) The Oil and Gas Lease is an asset of the developer which may be used to secure an obligation.
  - (2) The right to receive a share of production from land is an asset.
  - (3) The drilling company's right to payment

under a Drilling Contract is an asset.

(4) A gas purchaser's agreement to purchase gas in specified amounts at a specified price is an asset.

b. Tangible property interests. Real and personal property associated with the development of the land for oil and gas. For example:

- (1) Unextracted oil and gas.
- (2) Pumping unit, tubing, casing.
- (3) Flow lines, pipelines.
- (4) Separator, heater-treater, stock tanks.
- (5) Dehydrator, compressor.
- (6) Saltwater disposal tanks, saltwater injection well.
- (7) Equipment and supplies on the lease.
- (8) Extracted oil and gas.

#### IV. CLASSIFICATION OF OIL AND GAS PROPERTY

##### A. Mineral Interest.

1. Surface and mineral estates are real property. Froelich v. United Royalty Co., 178 Kan. 503, 507, 290 P.2d 93, 96 (1955), modified, 179 Kan. 652, 297 P.2d 1106 (1956).
2. Granting an oil and gas lease covering the mineral estate does not change ownership of the minerals. Merely burdens the mineral estate with contractual obligations specified in the oil and gas lease.

##### B. Oil and Gas Lease.

1. A "hybrid" property interest.
2. Classified as personal property. Burden v. Gypsy Oil Co., 141 Kan. 147, 150, 40 P.2d 463, 466 (1935).
  - a. Peculiar classification probably adopted to exempt oil and gas leases from K.S.A. §79-420 (1984).

- b. K.S.A. §79-420 does not apply to "leases" (although it was probably intended to do so). Gas Co. v. Neosho County, 75 Kan. 335, 337, 89 P.750, 751 (1907).
3. Oil and gas lease has been, in effect, reclassified by statute and judicial opinion to be treated as a real property interest in specified situations.

C. Royalty

1. A right to share in oil and gas when, and if, actually produced. Magnusson v. Colorado Oil and Gas Corp., 183 Kan. 568, 571, 331 P.2d 577, 580 (1958).
2. Classified as personal property. Magnusson.
3. However, courts consider the context in which the term "royalty" is used and, when appropriate, interpret references to royalty as an incorrect reference to the mineral interest - real property. In re Estate of Sellens, 7 Kan.App.2d 48, 637 P.2d 483 (1981).

D. Nonoperating Interests - Carved From The Leasehold.

1. Common nonoperating interests:
  - a. Overriding Royalty. A right to a share of oil and gas from the leased land free of the cost of production. Payable out of the working interest from which it is carved; will terminate when the lease terminates. Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965).
  - b. Production Payment. A right to a share of oil and gas from the leased land free of the cost of production but limited to a specified quantity or value of production. McCrae v. Bradley Oil Co., 148 Kan. 911, 84 P.2d 866 (1938) (quantity of production); Matthews v. Ramsey-Lloyd Oil Co., 121 Kan. 75, 245 P. 1064 (1926) (value of production).
  - c. Net Profits Interest. A right to a share of oil and gas from the leased land free of the cost of production but payable only if and when the lessee earns a net profit from his operations. Difficulty is defining what costs will be deducted from revenues to

determine whether a net profit has been realized. Kumberg v. Kumberg, 232 Kan. 692, 659 P.2d 823 (1983).

d. Convertible Interest. A nonoperating interest, such as an overriding royalty, may be convertible to an operating interest after the occurrence of a specified event, such as recovery of costs from a well. Commonly used in farmout transactions.

2. Nonoperating interests carved from the oil and gas lease, and representing the right to share in production when, and if, obtained, are personal property interests. Right to share in production when produced - like a royalty interest. Right created out of an oil and gas lease - a personal property interest.

#### V. CLASSIFICATION UNDER UCC ARTICLE 9

##### A. Oil and Gas Prior to Extraction.

1. Before oil or gas are produced from the land they are classified as real property.

2. Article 9 applies to any transaction intended to create a security interest in personal property or fixtures. K.S.A. §84-9-102 (1) (a) (1983).

a. Personal property includes goods, documents, instruments, general intangibles, chattel paper, or accounts.

b. Term "goods" does not include "minerals or the like (including oil and gas) before extraction." K.S.A. §84-9-105 (1) (h) (Supp. 1986).

c. "Security interest" is defined by K.S.A. §84-1-201 (37) (Supp. 1986) as: "[A]n interest in personal property or fixtures which secures payment or performance of an obligation." Under certain circumstances a "lease" intended as security will create a security interest.

d. Goods are "fixtures" when "affixing them to real estate so associates them with the real estate that . . . a purchaser of the real estate . . . would reasonably consider the goods to have been purchased as part of the

real estate." K.S.A. §84-9-313 (1) (a).

3. Article 9 does not apply to "the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder . . . ." K.S.A. §84-9-104 (j) (1983). See Ingram 214 Kan. 415.

4. CAUTION: K.S.A. §84-9-102 (3) (1983) provides:

"The application of this article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply."

- a. See Official UCC Comment #4 to K.S.A. §84-9-102.

- b. Although the underlying obligation is secured by collateral not subject to Article 9, for example a mortgage on an oil and gas lease, a pledge of the mortgage note as collateral for a loan will be subject to Article 9. See In re Southworth, 22 Bankr. 376 (1982) (right to receive payments under land sale contract is a personal property right); Wellsville Bank v. Nicolay, 7 Kan.App.2d 172, 638 P.2d 975 (1982) (assignment of rights in contract for sale of oil and gas lease).

B. Oil and Gas After Extraction.

1. In Kansas, oil and gas, while in the ground, are part of the real estate. When the oil and gas is actually produced, it becomes personal property. Anderson v. Beech Aircraft Corp., 237 Kan. 336, 342, 699 P.2d 1023 (1985).

2. Produced oil and gas are "goods."

- a. "[T]hings which are movable at the time the security interest attaches or which are fixtures . . . ." K.S.A. §84-9-105 (1) (h) (Supp. 1986).

- b. §84-9-105 (1) (h) also states oil and gas, prior to extraction, are not "goods."

C. Classification of "Goods."

1. Must classify to determine where to file the financing statement. K.S.A. §84-9-401 (Supp.

1986).

2. Classify to determine priority issues. K.S.A. §84-9-312 (Supp. 1986).
3. Classify to determine rights of purchasers of the goods. K.S.A. §84-9-307 (1983).

D. Oil and Gas as "Inventory."

1. "Goods are . . . 'inventory' if they are held by a person who holds them for sale . . . ." K.S.A. §84-9-109 (4) (1983).
2. Principal test - are the goods held for immediate or ultimate sale? If so, they are inventory. Official UCC Comment #3, K.S.A. §84-9-109.
3. When oil is produced, and put in tanks prior to sale, the oil is "inventory" since it is being held by the producer for sale.
4. Traditionally, seldom have an inventory of gas because it is sold at the wellhead. However, if the producer gathers gas and transports it through its pipeline to a delivery point, gas, prior to delivery, would be inventory of the producer.
5. With the emerging deregulated gas market, sales of gas may not take place until after transportation. Producer could have a considerable amount of gas in transit in a pipeline.

E. Oil and Gas as "Accounts."

1. "'Account' means any right to payment for goods sold . . . ." K.S.A. §84-9-106 (1983).
2. Account also includes the right to payment under an executory contract. See Kansas Comment to K.S.A. §84-9-106.
3. When oil or gas (inventory) is sold to a production purchaser, a "buyer in ordinary course of business," a creditor's right in the sold inventory is extinguished. The purchaser takes free of any security interest created by the seller; even though the security interest is perfected and the purchaser has knowledge of the perfected interest. K.S.A. §84-9-307 (1) (1983).
  - a. K.S.A. §84-1-201 (9) (Supp. 1986) defines "buyer in ordinary course of business" means:

"[A] person who in good faith and without knowledge that the sale to the person is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind . . . ."

- b. §84-1-201 (9) further defines "a person in the business of selling goods of that kind" as follows:

"All persons who sell minerals or the like (including oil and gas) at the wellhead or minehead shall be deemed to be persons in the business of selling goods of that kind."

4. Although a security interest in the inventory will be extinguished to the extent of a proper sale, the account created by the sale can be used as collateral.
5. If the sale is made under a contract which obligates the purchaser to buy the production at a stated price, the creditor's rights may extend to the gas sales contract instead of the extracted gas as inventory. Like other accounts, upon payment by the production purchaser, the account becomes a right to the proceeds of the sale.

F. Oil and Gas as "Proceeds."

1. "'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds . . . . Money, checks, deposit accounts, and the like are 'cash proceeds' . . . ." K.S.A. §84-9-306 (1) (1983).
2. Upon payment of an account, the creditor's interest shifts to the proceeds paid to satisfy the account.

G. Oil and Gas "Equipment."

1. Goods are "equipment" if: "[T]hey are used or bought for use primarily in business . . . and are not included in the definitions of inventory, farm products or consumer goods . . . ." K.S.A. §84-9-109 (2) (1983).
2. Major problem, in the oil and gas context, is distinguishing equipment from "fixtures."



H. Oil and Gas "Fixtures."

1. Goods become "fixtures" when they are affixed to the real estate to such an extent that a purchaser of the real estate would reasonably believe the affixed goods are included in the real estate sale. K.S.A. §84-9-313 (1) (a) (1983).
2. Security interest perfection requirements for equipment and fixtures are different.

I. Oil and Gas as "General Intangibles."

1. "General intangibles" include: "[A]ny personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments and money." K.S.A. §84-9-106 (1983).
2. In Kansas, because of their unique classification as personal property, it is arguable that a royalty, overriding royalty, production payment, and net profits interest are general intangibles.

VI. THE ARTICLE 9 SECURITY INTEREST

A. Creating the Security Interest - "Attachment."

1. Unless debtor authorizes the creditor ("secured party" under the UCC) to take possession of the collateral, an effective security interest can be created only after:
  - a. The parties enter into a written "security agreement" which manifests their intent to create or provide for a security interest.
  - b. The agreement contains a description of the collateral sufficient to inform third parties of the scope of the security interest.
  - c. The agreement is signed by the debtor.
  - d. The creditor has given "value" for the agreement.
  - e. The debtor has "rights in the collateral."K.S.A. §84-9-203 (1) (Supp. 1986).
2. The security interest "attaches" when all the events in 1.a.-e. have occurred; unless the parties agree to a later attachment. K.S.A.

§84-9-203 (2) (Supp. 1986).

3. "Value" is defined broadly by K.S.A. §1-201 (44) (Supp. 1986) to include traditional "consideration" as well as other interests which may not constitute consideration at common law. For example, security for a pre-existing claim.
4. "Rights in the collateral" is not defined by the UCC. Probably means the debtor must have some sort of ownership interest or right to use the collateral.

B. Perfecting the Security Interest.

1. Most oil and gas transactions require perfection by filing a "financing statement." K.S.A. §§84-9-302, 9-304, 9-305 (Supp. 1986); §84-9-303 (1983).
2. A security interest is perfected when: "[I]t has attached and when all the applicable steps required for perfection have been taken." K.S.A. §84-9-303 (1983).
3. The requirements for "perfection" of the security interest can vary depending upon the classification of the collateral.

C. The Financing Statement.

1. All financing statements must be in writing and contain the following:
  - a. The names of the debtor and the secured party.
  - b. Address of secured party who is able to provide additional information regarding the security interest.
  - c. Debtor's mailing address.
  - d. Statement indicating the types, or describing the items, of collateral.
  - e. Debtor's signature.

K.S.A. §84-9-402 (1) (1983).

2. The typical financing statement used in an oil and gas transaction must also contain:

a. A statement [as appropriate]:

(1) That it covers minerals, including oil and gas, before extraction and which attaches to such minerals as extracted, or which attaches to an account resulting from the sale of extracted minerals.

(2) That it covers goods that are or are to become fixtures.

b. Contain a legal description of the real estate concerned.

c. Identify the name of the record owner of the real estate concerned.

K.S.A. §84-9-402 (5) (1983); K.S.A. §84-9-313 (1983) (fixture filing).

3. NOTE: Kansas deviates from the 1978 Official Text of the UCC by not requiring that the financing statement "recite that it be filed for record in the real estate records." UCC §9-402 (1978).

4. Filing effective upon presenting the financing statement for filing and tendering the filing fee to the appropriate filing officer. K.S.A. §84-9-403 (1) (Supp. 1986).

5. Filing effective for five years from the date of filing. K.S.A. §84-9-403 (2) (Supp. 1986).

6. To maintain perfection of the security interest, must file a "continuation statement" within six months prior to expiration of the five-year effective period. K.S.A. §84-9-403 (3) (Supp. 1986).

7. Continuation statement not required for a real estate mortgage which is effective as a fixture filing. K.S.A. §84-9-403 (6) (Supp. 1986).

Not much help because, without filing a continuation statement, you will lose rights to your other personal property collateral - accounts, inventory, etc.

E. Where to File?

1. Must file in the correct place to perfect the security interest.

2. Two possible places to file:

- a. Office of the Secretary of State.
- b. Register of Deeds in the appropriate county.

K.S.A. §84-9-401 (Supp. 1986).

3. General Guide for Oil and Gas Property:

- a. Inventory, Accounts, Proceeds, Fixtures - file with the Register of Deeds in the county where the real estate concerned is located. K.S.A. §84-9-401 (1) (b) (Supp. 1986); K.S.A. §84-9-103 (5) (Supp. 1986); K.S.A. §58-2221 (1983).

- b. Equipment - File with the Secretary of State. K.S.A. §84-9-401 (c) (Supp. 1986).

- c. Interests Carved from the Working Interest - Treat same as oil and gas lease and file as a mortgage, treat as an interest "in minerals or the like . . . before extraction and which attaches thereto as extracted, or with attaches to an account resulting from the sale thereof . . ." and file under the UCC with the Register of Deeds.

Could they be "general intangibles?" If so, must file with Secretary of State. K.S.A. §84-9-401 (c) (Supp. 1986).

- d. Pipelines - if "primarily engaged in the . . . transmission of goods by pipeline" debtor may qualify as a "transmitting utility" under K.S.A. §84-9-105 (1) (n) (Supp. 1986). Perfect security interest in collateral by filing with Secretary of State. K.S.A. §84-9-401 (5) (Supp. 1986).

CAUTION: May be special statutes concerning perfection of a security interest in collateral owned by a public utility. See, e.g., K.S.A. §17-630, §17-631 (1981); K.S.A. §66-1217 (1985).

NOTE: Most oil and gas producers will not be "primarily engaged in the transmission of goods by pipeline." To perfect security interest in gathering lines must file with Register of Deeds in each county where the lines are located.

- e. Multi-state transactions; Conflicts problems. K.S.A. §84-9-103 (Supp. 1986).

4. Practical Guide for Oil and Gas Property:

- a. You never know when a "fixture" might be classified as "equipment." Also run the risk that various interests in oil and gas may be classified as "general intangibles." Therefore, FILE WITH THE REGISTER OF DEEDS AND THE SECRETARY OF STATE.

- b. Since the oil and gas lease, and probably interests carved from the oil and gas lease, must be filed as a mortgage on real property, consider the following practice:

PREPARE ONE DOCUMENT TO SERVE AS THE MORTGAGE, THE SECURITY AGREEMENT, AND THE FINANCING STATEMENT.

RECORD THE DOCUMENT "MORTGAGE, SECURITY AGREEMENT, FINANCING STATEMENT" WITH:

- (1) REGISTER OF DEEDS AS A MORTGAGE.
- (2) REGISTER OF DEEDS AS A UCC FINANCING STATEMENT (Ensure it is cross-indexed with the real estate search files).
- (3) SECRETARY OF STATE AS A UCC FINANCING STATEMENT.

MAINTAIN UCC FILINGS WITH CONTINUATION STATEMENTS. K.S.A. §84-9-403 (2) (Supp. 1986).

F. Foreclosure Of The Security Interest.

- 1. Security Agreement defines events constituting default.
- 2. Security Agreement may also specify the secured party's rights and remedies upon default - subject to limitations specified in §84-9-501 (3) (1983).
- 3. "If the security agreement covers both real and personal property, the secured party may proceed under this part as to the personal property or he may proceed as to both the real and the personal property in accordance with his rights and remedies in respect of the real property in which case the provisions of this part do not apply."

K.S.A. §84-9-501 (4) (1983).

4. "Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action . . . ."

K.S.A. §84-9-503 (1983).

- a. Debtor can voluntarily surrender collateral.
  - b. Secured party can use self-help to recover collateral. Cannot breach the peace.
  - c. Can use judicial procedures. K.S.A. §§60-1005 and 60-1006 (1983).
5. Upon default "the secured party is entitled to notify an account debtor . . . to make payment to him . . . and also to take control of any proceeds to which he is entitled . . . ."

K.S.A. §55-9-502 (1) (1983).

6. Collateral must be disposed of in a commercially reasonable manner. K.S.A. §84-9-504 (1) (1983).
  - a. Proceeds of sale. K.S.A. §84-9-504.
  - b. Sale procedure. K.S.A. §84-9-504 (3).
  - c. Rights of purchaser at sale. K.S.A. §84-9-504 (4).
  - d. Unless otherwise agreed, debtor liable for any deficiency. K.S.A. §84-9-502 (2) (1983).
7. Retention of collateral to satisfy debt. K.S.A. §84-9-505 (2) (1983) (strict foreclosure).
8. Collateral redemption rights. K.S.A. §84-9-506 (1983).
9. Secured party liability for improper foreclosure. K.S.A. §84-9-507 (1983).

G. Priority Of The Security Interest.

1. Unperfected security interest is subordinate to:
  - a. Unperfected security interests which attached

prior in time. K.S.A. §84-9-312 (5) (b) (Supp. 1986).

- b. All perfected security interests. K.S.A. §84-9-312 (5) (a) (Supp. 1986).
- c. A person who becomes a lien creditor before perfection. K.S.A. §84-9-301 (1) (b) (Supp. 1983).

Lien creditor includes "a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for benefit of creditors from the time of assignment and a trustee in bankruptcy from the date of filing the petition or a receiver in equity from the time of appointment."

K.S.A. §84-9-301 (3) (Supp. 1986).

- d. Purchasers of the collateral for value without notice of the security interest. Bulk sales - not in the ordinary course of business. K.S.A. §84-9-301 (1) (c), (1) (d).
  - e. Purchasers of the collateral in the ordinary course of business - even though they have notice of the security interest. K.S.A. §84-9-307 (1) (1983).
  - f. Special protection for creditor advancing money to purchase the collateral (purchase money security interest). Creditor given up to 20 days after debtor receives possession of collateral to file financing statement. Will take priority, as to the collateral purchased with the advanced funds, over a sale of the collateral in bulk, or lien creditor rights, which arise between attachment of the security interest and its filing. K.S.A. §84-9-301 (2) (Supp. 1986).
  - g. Mechanics' liens where the labor or supplying commenced prior to attachment of the lien. Not clear whether the reference to "attach" in the lien statute means "perfect." K.S.A. §55-207 (1983). See K.S.A. §84-9-310 (1983).
2. Perfected security interest is subordinate to:
- a. Perfected security interests filed prior in time. K.S.A. §84-9-312 (5) (a) (Supp. 1986).

- b. Mechanics' liens where the labor or supplying commenced prior to attachment of the lien. K.S.A. §55-207 (1983).

NOTE: K.S.A. §55-214 (1983). Oil-field equipment transporter's lien "shall not be prior to any valid and existing perfected security interest."

- c. Absent statutory change, possessory lien takes priority over a perfected security interest. K.S.A. §84-9-310 (1983).

NOTE: Could this assist an operator? Arguably they are in possession furnishing services or materials in the ordinary course of business. Lien given by statute or "rule of law" is superior to perfected security interest unless the lien is statutory and the statute expressly provides otherwise.

- d. Sales in the ordinary course of business. K.S.A. §84-9-307 (1) (1983).



## VII. STATUTORY LIENS - THE MECHANIC'S LIEN

### A. Introduction.

#### 1. Function of the Mechanic's Lien:

"[T]he basic purpose of lien statutes . . . is to create a new means of securing claims of particular classes of creditors and to prevent unjust enrichment of property from which work and materials expended thereon would otherwise be without payment . . . ."

Permian Corporation v. Armco Steel Corporation, 508 F.2d 68, 75 (10th Cir. 1974).

"The principle upon which the mechanic's lien rests is, in a sense, that of unjust enrichment. Ordinarily, it is the equity arising from assumed enhancement in value resulting from work or materials expended upon the property without payment therefor which is laid hold of to protect workmen and others who, it is assumed, are especially deserving, would ordinarily fail to provide by agreement for their own protection and would often be unable to do so."

Piedmont & Georges Creek Coal Co. v. Seaboard Fisheries Co., 254 U.S. 1, 9-10 (1920).

"[F]undamental principle underlying the provision of mechanics' liens is unjust enrichment."

DaMac Drilling, Inc. v. Shoemaker, 11 Kan.App.2d 38, 46, 713 P.2d 480 (1986).

2. However, even though providing the services or materials may give rise to a claim of unjust enrichment, the right to a statutory lien and the scope of the lien, are governed by statute.

3. The statutory lien is interpreted narrowly to limit the benefits of the statute to claimants and situations clearly coming within its express terms. Calvert Western Exploration Co. v. Diamond Shamrock, 234 Kan. 699, 707, 675 P.2d 871 (1984).

- a. "Oil and gas lien laws confer special privileges, are to be strictly construed against one claiming the privilege, and their scope is not to be extended beyond that clearly granted by the legislature."

Calvert Western, 234 Kan. at 707.

- b. Must carefully comply with all technical requirements dictated by statutes. DaMac Drilling, Inc. v. Shoemaker, 11 Kan.App.2d 38, 40, 713 P.2d 480 (1986).

- 4. Oil and gas lien statute - major contender for the "worst written statute" award for Kansas.

B. Who Is Entitled To A Lien?

- 1. Any person who, under an express or implied contract, with the "owner of any leasehold for oil and gas purposes" [or owner of an oil or gas pipeline], or their agent, provides:

Labor, material, machinery, or supplies used:

- a. In "digging, drilling, torpedoing [perforating], completing, operating or repairing of any oil or gas well" or
- b. In constructing "machinery" used in "drilling, torpedoing, operating, completing or repairing any gas well . . . ."

K.S.A. §55-207 (1983).

- 2. Any person who performs §55-207 labor as a subcontractor of the §55-207 contractor. K.S.A. §55-208 (1983).
- 3. Any person who furnishes §55-207 machinery or supplies "to a subcontractor under a [§55-207] contractor . . . ." K.S.A. §55-208 (1983).
- 4. Supplier to a materialman not entitled to a lien under the statute. Interlake, Inc. v. Kansas Power & Light, 231 Kan. 251, 644 P.2d 385 (1982).
- 5. Any person who transports "oil-field equipment," as defined by K.S.A. §55-212 (b) (1983), under express contract with the owner or operator of an oil and gas lease, pipeline, or owner of oil-field equipment, or their agent. K.S.A. §55-213 (1983).
- 5. Who is the "owner of any leasehold for oil and gas purposes . . . ."?
  - a. Apparently, any owner of an undivided interest in the leasehold could contract with the lien claimant.

- b. Can the owner of an undivided 1% of the leasehold operating interest subject the entire lease to a lien?
7. "Subcontractor," as used in K.S.A. §55-208 (1983), requires a preexisting contract between the owner and the contractor. The contractor then enters into an agreement with the subcontractor to perform all or part of the contract between the owner and contractor. Calvert Western Exploration Co. v. Diamond Shamrock, 234 Kan. 699, 704-05, 675 P.2d 871 (1984).
8. Transporter of oil-field equipment must look to K.S.A. §§55-212, -213, -214, and -215 (1983) to establish right to lien. Cannot rely on more general provisions of K.S.A. §§55-207, -208, -209, and -210 (1983). Note, however, court also made finding transportation services not covered by K.S.A. §55-207 (1983). Calvert Western, 234 Kan. at 707.
9. What is encompassed by the term "labor?"
- a. May involve "manual or mental" work.
- K.S.A. §55-207 includes "Work performed in the on-site advancement of the construction, repair or operation of an oil or gas well such that the leasehold owner would be unjustly enriched if not burdened by a lien . . . ."
- DaMac Drilling, Inc. v. Shoemaker, 11 Kan.App.2d 38, 46, 713 P.2d 480 (1986).
- b. Services [examination of well cuttings, preparation of daily logs, supervision of testing procedures] of a professional geologist, performed at the drill site, are "labor" covered by K.S.A. §55-207 (1983). DaMac Drilling, 11 Kan.App.2d at 46.
- c. Court in DaMac Drilling focuses on two factors:
- (1) Is it likely third parties would have notice of the work being performed? 11 Kan.App.2d at 45-46 (distinguish in-house feasibility studies from work at drill site - see a rig drilling you can anticipate there will be a geologist at the well performing on-site services).

(2) Does the on-site geologist provide valuable services so that nonpayment would unjustly enrich the leaseholder? 11 Kan.App. 2d at 46 (tangible benefit provided through geologist's services).

10. Lease of machinery not protected by oil and gas lien statutes. Calvert Western Exploration Co. v. Diamond Shamrock, 234 Kan. 699, 702, 675 P.2d 871 (1984).

- a. Court will examine the transaction to determine: Whether the parties created merely a lease of personal property or is the personal property being supplied as part of a package deal comprising personnel, equipment, and services?
- b. Typical drilling contract requires the rig owner to provide much more than merely the use of the drilling rig. Calvert Western, 234 Kan. at 703-04.
- c. Contract to provide casing held to be a lease instead of a sale. No right to lien for rental value of casing. Wilkinson v. Pacific Mid-West Oil Co., 152 Kan. 712, 107 P.2d 726 (1940).

C. What Property Interests Are Subject To The Lien?

1. Person entitled to a lien:

"[S]hall have a lien upon:

- a. "the whole of such leasehold [or pipeline],
- b. "or lease for oil and gas purposes,
- c. "the building and appurtenances,
- d. "and upon the material and supplies so furnished,
- e. "and upon said oil and gas well for which they were furnished,
- f. "and upon all the other oil wells, fixtures and appliances used in the operating for oil and gas purposes upon the leasehold for which said material and supplies were furnished and labor performed . . . ."

K.S.A. §55-207 (1983).

2. Subcontractor or materialman entitled to lien "to the same extent as the original contractor . . . ." K.S.A. §55-208 (1983).
3. Oil-field equipment transporter's lien limited to "the interest of such owner [person transporter contracted with] in the oil-field equipment so transported and hauled." K.S.A. §55-213 (1983).
  - a. If person transporter contract's with does not own any interest in the transported equipment, transporter cannot create a lien against the equipment. Calvert Western, 234 Kan. at 706.
  - b. Ascertain ownership interest of person you contract with; if they have no ownership interest, are they acting as an authorized agent for someone with an ownership interest? What is the extent of the ownership interest?
  - c. Note: Under §55-207 if the contract for labor or materials is not with "the owner of any leasehold," can have a similar problem.
4. Does the lien encumber 100% of the rights created by or out of an oil and gas lease?
  - a. Does not encumber the royalty payable to the landowner under the oil and gas lease. Dicta, DaMac Drilling, Inc. v. Shoemaker, 11 Kan.App.2d 38, 49, 713 P.2d 480 (1986).
  - b. Does not encumber overriding royalty interests carved from the working interest and recorded prior to the lien attaching. DaMac Drilling, 11 Kan.App.2d at 49.
  - c. Does not encumber oil and gas once produced. DaMac Drilling, 11 Kan.App.2d at 49 (citing Black v. Giarth, 88 Kan. 338, 128 P. 183 (1912)).

NOTE: This would also exclude any lien on inventory, accounts, and production proceeds.

- d. Black v. Giarth, 88 Kan. 338, 128 P. 183 (1912), court interpreting effect of Oklahoma oil and gas mechanics' lien statute. However, court notes it is identical (then) to the Kansas statute.

"The statute makes no attempt to fasten the lien upon the lessor's real estate, or to extend it beyond the interest of the lessee. As he has no title to the oil so long as it remains in the earth . . . , no lien can attach to it as his property until it is brought to the surface and when that has been done it is clearly no part of the well."

Black, 88 Kan. at 340.

The Oklahoma statute discussed in Black is very similar to K.S.A. §55-207 (1983).

- d. Lien probably encumbers 100% of the lease working interest. DaMac Drilling, 11 Kan.App.2d at 48-49.

- (1) Shifts the burden for unauthorized or unpaid lease development and operation costs to the parties most likely to benefit from the labor or material.
- (2) A owns a 50% undivided interest in the Smith Oil and Gas Lease. B owns the other 50% undivided interest.

A and B are cotenants. Each can independently develop the property.

Suppose A contracts with Acme to drill a well. Acme performs, the well is dry, A fails to pay Acme. Acme perfects a lien against "the whole of the Smith Oil and Gas Leasehold." Acme's lien is foreclosed and the interest subject to the lien is ordered sold. Will the sheriff sell only A's undivided 50% interest or the full 100% working interest in the Smith Lease?

- (3) Consider Ball v. Oil & Gas Co., 113 Kan. 763, 216 P. 422 (1923). Owner of 7/8ths of the leasehold contracted to operate the lease and pay 1/8th of production to owner of remaining 1/8th of the leasehold. Liens created by owner of 7/8ths burden the entire (8/8ths) leasehold estate. "[T]he lien for labor or material extends to the whole property - to the entire lease and its equipment."

Ball, 113 Kan. at 771.

- e. Suppose you have a single lease covering 640 acres. The lease has two 320 acre drilling units. Investor Group A drills a well on Drill Site A; it is a dry hole. The drilling contractor is not paid. Meanwhile, Investor Group B drills a producing well on Drill Site B. Can Drill Site B be foreclosed to pay the drilling costs associated with Drill Site A?

Although the promoter for each Drill Site may be the same, the investors holding working interests in the two drill sites comprising the 640 acre lease may be different.

Result may depend upon recording of the interests and the ability of the drilling contractor to claim they relied upon the value of the entire 640 acre tract in determining whether to advance credit to the promoter.

- f. Consider Confinement Specialists, Inc. v. Schlatter, 6 Kan.App.2d 1, 626 P.2d 223 (1981), pet. for rev. denied, 229 Kan. 669.

Improvement on 9.9 acres did not limit land subject to general mechanics' liens; landowners' 160 acres, owned at the time the contract for improvements was made, constituted the "property" subject to the lien. However, ownership of the 9.9 acre tract and balance of the quarter section were the same.

D. When Does The Lien Attach?

1. Lien attaches when labor, material, or machinery are first supplied by the lien claimant. K.S.A. §55-207 (1983).
2. If labor, material, or machinery are supplied on more than one occasion, even though pursuant to separate contracts, can use a single lien statement to perfect the lien claim so long as no more than 4 months have elapsed since providing services. K.S.A. §55-207 (1983).
  - a. If 4 months have elapsed, must file a lien statement for the prior services within 6 months after the date the services were last furnished. K.S.A. §55-209 (1983).
  - b. Practical effect: avoid having to file multiple lien statements when services are of

a continuing nature.

3. Oil-field equipment transporter's lien attaches when the equipment was "transported and delivered." K.S.A. §55-214 (1983).

E. How Is The Lien Perfected?

1. Perfect the lien by filing a "lien statement" within 6 months after the date material was last furnished or labor last performed. K.S.A. §55-209 (1983).
2. File with the District Court Clerk of the county where the land and the leasehold are located. K.S.A. §55-209 (1983).
3. Contents of the Lien Statement:
  - a. Amount claimed.
  - b. Description of the items comprising the claim.
  - c. Name of the owner of the land.
  - d. Name of the owner of the leasehold.
  - e. Name of the contractor.
  - f. Name of the claimant.
  - g. Description of the real and personal property subject to the lien.
  - h. Affidavit verifying the truth of statements made in the Lien Statement.

K.S.A. §55-209 (1983).

NOTE: Special provision if the debt is evidenced by a promissory note. See §55-209 (Proviso).

4. If lien claimant is a supplier, subcontractor, or other person furnishing labor supplies, or machinery "under an agreement with the contractor, subcontractor, or owner contractor," must also follow the requirements of K.S.A. §60-1103 (c) (Supp. 1986).
  - a. Claimant must serve a copy of the Lien Statement on "any one owner of the property and any party obligated to pay the lien . . . . " K.S.A. §60-1103 (c).



- b. If address of any one owner or a party is unknown, post a copy of the Lien Statement in a conspicuous place on the premises. K.S.A. §60-1103 (c).
  - c. K.S.A. §55-210 (1983) provides: "notice of the same [all liens for labor and materials] shall be given in the same manner (whether by the contractor, subcontractor, the materialman or laborer) as may be provided by law for enforcing liens of mechanics and others against real estate."
  - d. Notice to owner of leasehold is essential to create a valid subcontractor's lien. Mountain Iron & Supply Co. v. Branum, 200 Kan. 38, 434 P.2d 1015 (1967).
5. Oil-field Equipment Transporter's Lien
- a. Must file Lien Statement within 120 days after the oil-field equipment was transported and delivered. K.S.A. §55-214 (1983).
  - b. File with the District Court Clerk in the county where the equipment was delivered. K.S.A. §55-214.
  - c. Serve a copy of the statement upon the owner of the equipment by registered mail. Owner then obligated to give claimant written notice before the equipment is moved from the leasehold where delivered. K.S.A. §55-214.
- If all or part of the equipment is moved to another county, claimant has 30 days after receiving notice of the move (from the equipment owner) to file a copy of the lien with the District Court Clerk for the county where the equipment has been moved. K.S.A. §55-214.
- d. The Lien Statement must contain:
    - (1) Amount claimed.
    - (2) Description of items comprising the claim.
    - (3) Name of the owner of the equipment.
    - (4) Name of the contractor of the equipment.

(5) Name of the claimant.

(6) Full description of the property subject to the lien.

(7) Affidavit verifying the truth of statements made in the Lien Statement.

K.S.A. 55-214 (1983).

**F. Foreclosure Of The Lien.**

1. Liens for labor and materials - enforced in the same manner as general mechanics liens. K.S.A. §55-210 (1983).

K.S.A. §§60-1101, -1102, -1104, -1105, -1106, -1107, -1108, -1109, -1110 (1983); K.S.A. §60-1103 (Supp. 1986).

2. Foreclosure action must be brought within one year from the time the Lien Statement is filed. K.S.A. §60-1105 (1983).

Note: Period is within one year from maturity of promissory note if note attached to Lien Statement in lieu of an itemized statement. K.S.A. §60-1105 (1983); K.S.A. §55-209 (1983).

3. K.S.A. §60-1106 (1983) requires all lien claimants and other encumbrancers of record to be joined in the foreclosure action. When lien claimant is not the original contractor, must join the original contractor.
4. Owner of land subject to liens can file action to determine their validity. K.S.A. §60-1108 (1983).
5. No redemption rights in the property sold to satisfy lien. K.S.A. §55-210 (1983). See also K.S.A. §60-2414 (a) (1983) ("The right of redemption shall not apply to oil and gas leaseholds.").
6. "All other liens and mortgages on leaseholds for oil and gas purposes shall be enforced and foreclosed in the same manner as may be provided by law for enforcing liens and mortgages against real estate." K.S.A. §55-210 (1983).

See generally Kansas Real Estate Practice and Procedure Handbook §6.6 (Kansas Bar Association 1985).

7. After lien claimant obtains a judgment, provisions of K.S.A. §§60-2401 et seq. (1983) govern the execution of the judgment.

G. Priority Of Lien.

1. Lien for labor and material has priority over all other liens or encumbrances which "attach" after "the commencement of or the furnishing or putting up of any . . . machinery or supplies." K.S.A. §55-207 (1983).

- a. Term "attach," as used in §55-207, probably requires perfection so the person about to provide services can ascertain the unencumbered value of the contractor's leasehold interest.

- b. Would the dirt mover, who provided services three days before the driller commenced providing services, have priority over the driller?

When K.S.A. §55-207 refers to a preference over "all other liens," does this include other mechanics liens arising out of the same leasehold project?

- c. Pickering Lumber Co. v. Eisenhower, 125 Kan. 738, 264 P. 144 (1928), indicates properly perfected mechanics' liens all have the same priority regardless of when each commenced their work.

2. Oil-field equipment transporter's lien "shall be of equal standing with the contractor's lien provided by K.S.A. 55-207." K.S.A. §55-213 (1983).

K.S.A. §55-214 (1983) provides the oil-field equipment transporter's lien "shall not be prior to any valid and existing perfected security interest" in the equipment.

3. "When two or more such contracts [for labor or materials] are entered into applicable to the same improvement, the liens of all claimants shall be similarly preferred to the date of the earliest unsatisfied lien of any of them." K.S.A. §60-1101 (1983).

"If the proceeds of the [foreclosure] sale be insufficient to pay all the claimants, then the court shall order them to be paid in proportion to

the amount due each." K.S.A. §60-1109 (1983).

H. Recurring Problems.

1. Verification of the Lien Statement.

- a. "The purpose of a verification is to verify the truth of the matter set forth in the document being verified. A verification is an affidavit attached to a statement as to the truth of the matters therein set forth."

Trane Co. v. Bakkalapulo, 234 Kan. 348, 672 P.2d 586 (1983) (Syllabus #1).

- b. "Cases finding lien statement verifications to be flawed have fallen into one of three categories: (1) those which fail to reveal the agency of the signer so that they are not verifications by the claimant . . . ; (2) those which do not verify the truth of the statement because the verification wording merely acknowledges the statement's execution . . . or because the verification was not properly notarized . . . ; and (3) those verifications which are qualified."

Kansas Lumber Co. v. Wang, 12 Kan.App.2d 20, 23 (1987).

- c. Statement that matters contained in Lien Statement were true to the "best of his [claimant's] knowledge, information and belief" qualifies the verification and makes it inadequate. Proper verification of the Lien Statement is a prerequisite to the creation of a valid lien. DaMac Drilling, Inc. v. Shoemaker, 11 Kan.App.2d 38, 40-41, 713 P.2d 480 (1986).

2. Scope of Lien.

- a. Most Lien Statements purport to cover production from the lease. Kansas lien statutes do not grant a lien on production - need a consensual lien to accomplish this. See Black v. Giarth, 88 Kan. 338, 128 P. 183 (1912).
- b. Lien will most often encumber the entire leasehold interest. Adair v. Transcontinental Oil Co., 184 Kan. 454, 338 P.2d 79 (1959).

In Adair the court applies a fictional "agency by operation of law" to subject leasehold owner to lien contracted for by its conditional vendee. Agency for the limited purpose of authorizing the lien to attach to the owner's leasehold interest. Adair, 184 Kan. at 464.

Underlying goal is to prevent unjust enrichment of the owner at the expense of the lien claimants.

- c. Most operating agreements will create an express or implied agency to contract for services, etc. Although the nonoperators may not be personally liable for the debt, their interest in the leasehold will be subject to mechanic's liens.

### 3. Lienable Items.

- a. Entitled to a lien only for items actually "used" in drilling, completing, operating, or repairing oil and gas wells. Fender Pipe & Supply, Inc. v. Jenkins, 5 Kan.App.2d 101, 612 P.2d 1253 (1980) (lien for tubing used in well; no lien for rods stored on lease but never used).
- b. Entitled to a lien only for labor, material, machinery, and oil-well supplies.
  - (1) Flat rate monthly lease supervision charge?
  - (2) Accounting services, attorney fees, abstracting fees, conservation commission hearing preparation and presentation?
  - (3) Insurance, KIOGA dues, late payment penalties, electricity?
  - (4) Need consensual lien to assert right to most of these items.
- c. Scope of statutory lien much narrower than consensual lien typically granted operator in operating agreement.

VIII. SPECIAL SECURED POSITION PROBLEMS

A. Bankruptcy Of The Debtor.

1. Automatic Stay.

- a. Filing of bankruptcy petition stays of all proceedings concerning the property subject to the bankruptcy proceeding. 11 U.S.C. §362 (a).
- b. Includes any act to create, perfect, or enforce a lien against property subject to the proceeding (the bankruptcy "estate").
- c. Exception - mechanics liens which attach before filing the petition but have not been perfected by filing the Lien Statement. 11 U.S.C. §546 (b) permits perfection, and relation back for priority purposes, to the extent allowed by state law.

Purchase money security interest. K.S.A. §84-9-301 (2) (Supp. 1986). But see 11 U.S.C. §547 (e) (2) (B) (10 day limit to prevent purchase money security interest from being a preference).

- d. Relief from the Stay. Stay can be lifted to the extent creditor can demonstrate:
  - (1) Their security is likely to decrease in value without protection from the court.
  - (2) The debtor has no equity in the property and the property is not necessary for reorganization.

11 U.S.C. §362 (d).

2. Trustee's Power to Avoid Unperfected Security Interests.

- a. As of date petition filed, trustee (debtor in possession) assumes the status of a hypothetical lien creditor. 11 U.S.C. §544 (a).
- b. "Strong-arm" clause permits the trustee to avoid unperfected security interests that are subordinate to a judicial lien creditor.

- c. Trustee also assumes the status of a bona fide purchaser of the debtor's real estate; excluding fixtures. Allows trustee to avoid mortgages, and other interests in real estate, if not recorded prior to the filing of the petition.
- 3. Trustee's Power to Set Aside Transfers to Creditors.
  - a. Trustee can set aside a transfer made by the debtor, to the creditor, to be applied on a preexisting debt. Debtor must be insolvent when the transfer is made, and the transfer must occur within 90 days of filing the petition (or within 1 year if the creditor is classified an "insider.") The transfer must enable the creditor to receive more than if the debtor's estate had been liquidated.

11 U.S.C. §547.
  - b. Exceptions: 11 U.S.C. §547 (c).
  - c. Fraudulent conveyances. 11 U.S.C. §548.
- 4. Trustee's Power to Avoid Executory Contracts and Unexpired Leases.
  - a. Trustee can elect to assume or reject executory contracts and unexpired leases. 11 U.S.C. §365.
  - b. Oil and gas lease an executory contract? In re J.H. Land & Cattle Company, Inc., 8 Bankr. 237 (Bankr. W.D. Okla. 1981) (applying law to an oil and gas lease covering Kansas land).
- 5. Trustee's Power to Use and Sell Property.
  - a. Trustee can, under certain circumstances, sell property in the bankruptcy estate and give clear title to the purchaser. 11 U.S.C. §363 (f), (h), (i).
  - b. Trustee can deal with bankruptcy estate property when operating the debtor's business and acting in the ordinary course of business. 11 U.S.C. §363 (c) (1).
- 6. Effect of Bankruptcy on Changes in the Form of Collateral.

- a. In re Hess, 61 Bankr. 977 (Bankr. N.D. Tex. 1986). 11 U.S.C. §552 (a) - Property acquired by estate or by the debtor after commencement of bankruptcy proceeding not subject to any lien resulting from any security agreement entered into by debtor before filing petition.
- b. Is post-petition production from land, in which creditor has a mortgage and perfected security interest, a new acquisition of property by the estate? If so, not subject to pre-petition security agreement.
- c. Relying on the rule of capture, debtor argues it had no "rights" in the post-petition production until it reaches the surface. Argues when oil and gas change from real to personal property it becomes a new asset.
- d. Court holds debtor has rights in the collateral even though not captured, stating:

"The Debtors do not acquire any new 'rights' in the oil and gas as it is produced; they had 'rights' in the oil and gas before it was produced. The change of legal designation from real property to personal property does not dislodge the Debtors' ownership nor the Bank's liens. In effect, the Bank has a continuous lien on the oil and gas, wherever located."

In re Hess, 61 Bankr. at 979.

- e. Rationale in Hess may be useful in a number of bankruptcy and non-bankruptcy contexts.
7. See generally Kansas Bankruptcy Handbook (Kansas Bar Association (2d ed. 1986)). An excellent work.

Another valuable resource - "Oil & Gas Bankruptcies: Quick Kicking From the End Zone," by Walker Hendrix and Martin W. Bauer (Third 1986 CLE-Football Weekend Series Seminars - Kansas Bar Association, November 15, 1986).

## B. Unrecorded Oil and Gas Property Interests.

1. Operating agreements, farmout agreements, leasehold assignments, production sales contracts, and other agreements affecting real property are often, for various reasons, not filed for record.



2. Run the risk of losing to a bona fide purchaser. Most often the trustee in bankruptcy.
3. Often the agreement creates lien rights. Must perfect by proper filing to benefit from the lien.

C. Devaluation of Collateral.

1. Failure to operate property.
2. Market forces which decrease the value of collateral (over night).

D. Need to Protect Secured Position.

1. Typical oil and gas lease has many "special limitations" on the continued existence of the grant.
2. If debtor fails to take care of business, may end up losing the collateral through a reversion to the lessor/landowner.
3. Automatic reversion, provided for in the lease contract, would not be affected by the automatic stay in bankruptcy.
4. Need to police distressed operations more closely and be in a position to act, or decide not to act, before the collateral (oil and gas lease) is lost.

**Title: CREATING, PROTECTING, AND FORECLOSING  
A SECURED POSITION IN OIL AND GAS**

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