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E&P Lending: Due Diligence and Collateral Legal Issues in E&P Lending Deals for the Texas Law Man in Particular

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E&P LENDING: DUE DILIGENCE AND COLLATERAL LEGAL ISSUES IN E&P LENDING DEALS FOR THE TEXAS LAW MAN IN PARTICULAR

By: Jason A. Schumacher

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Oil and gas companies frequently use debt financing in order to provide the large capital required to explore and develop large-acreage blocks. With the rise of horizontal drilling in combination with multi-stage hydraulic fracturing, the average cost per well has skyrocketed. In order to access a bank’s cheaper money, an oil and gas company normally must have already found something worth finding. In return for a beneficial interest rate from a bank (as opposed to splitting the profits of the company with equity partners or paying mezzanine debt interest rates), the oil and gas company must

get more ducks in a row than it had to get in a row to raise money from their friends and family, a venture equity, or a mezz debt source. Additionally, due to the special characteristics of oil and gas as an asset, special legal issues exist for bank lenders to navigate to insure they can recover on collateral in a first-priority lien position in the event that the oil and gas company borrower goes into bankruptcy.

This Article explores the legal due diligence process of an oil and gas loan deal—addressing both the roles of the borrower’s counsel and the lender’s counsel in the process. Further, it addresses unique issues related to properly securing the collateral of an oil and gas company borrower under Texas law. It should be noted that this Article is related to exploration and production (E&P) companies, not companies involved with the midstream or downstream side of the business. This Article focuses on oil and gas properties located in the state of Texas; while the collateral rules will be almost the same in other states, only the Texas law perspective will be discussed.

Some capitalized terms will be used. The term “Energy Lender” refers to a lender in an oil and gas loan transaction. The term “Borrower” refers to an oil and gas company borrowing money from an Energy Lender.

I. DUE DILIGENCE IN OIL AND GAS LENDING DEALS

A. *Due Diligence from the Lender’s Perspective*

Oil and gas loan deals have their own unique, industry-specific due diligence concerns and processes. The Energy Lender is concerned about (i) identifying any material issues that would affect the Energy Lender’s assessment of the risk related to the Borrower having the Energy Lender’s money and not being able to return it, and (ii) identifying any material issues regarding the Borrower’s collateral. In order to identify these issues, the Energy Lender’s legal counsel must perform numerous tasks—some of which are set forth in this section.

1. Review of Material Contracts

The Energy Lender is concerned with the following issues regarding the Borrower’s material contracts:

- Whether the Borrower has appropriate contracts with all of its counterparties;
- Whether the Borrower has any unusual payment obligations outside the industry norms;
- Whether any of the contracts grant liens against the Energy Lender’s collateral; and
- Whether the contract is collaterally assigned.

Some of the contracts that are material and unique to oil and gas lending are as follows:

- Joint Operating Agreements (JOAs);
- Liens granted to the other parties for failure to pay obligations under the standard form of JOA, which can supersede the Lender's lien;¹
- Forms of oil and gas leases;
- Production sales agreements;
- Hedging agreements (Lender should understand what happens under these agreements if Lender must foreclose or takes a collateral assignment of such contracts. Lender also may require that a certain percentage of the oil and gas company's production be subject to hedge agreements); and
- Forms of rights of way and easements—particularly important for E&P companies that have built substantial gathering lines or pipelines to be able to sell their production.

Energy Lenders are often resistant to reviewing the material contracts and are instead comfortable relying on the Borrower's representations and warranties related to the Borrower's material contracts. Why are Energy Lenders resistant? The cost and time involved with reviewing all of a company's material contracts can be substantial, and the Energy Lender knows that the Borrower evaluates the Energy Lender in terms of how easily the transaction is completed. What is the risk involved in taking this approach? In the event that the Borrower goes bankrupt, there will most likely be various defaults under the Loan Agreement (such as payment defaults). Additionally, breaches of representations and warranties are not necessary to trigger the Energy Lender's remedies to the collateral, and the bankruptcy court will not give the Energy Lender extra credit points for asserting breaches of representations and warranties in its bankruptcy filings. As such, if there is a smoking gun in the terms of the material contracts, it is that the Energy Lender's position as a secured lender with first priority in the bankruptcy proceeding could be jeopardized or that the assets of the Borrower could be subject to burdens that cripple the Energy Lender's ability to recover the perceived value of those assets when the Energy Lender made the decision to lend money to the Borrower.

The Energy Lender's counsel must communicate the risk involved in not looking through the material contracts. Additionally, if the loan is to be syndicated, and the Energy Lender is to be an agent for a group of lenders, the Energy Lender must carefully weigh its obligations to the other banks involved.

1. *See generally* MBank Abilene v. Westwood Energy, Inc., 723 S.W.2d 246 (Tex. App.—Eastland 1986, no writ) (holding that liens granted by a non-recorded JOA trump liens recorded subsequently by lender).

2. Lien Searches

Lien searches allow the Energy Lender to ensure that the Energy Lender receives priority in the Borrower's collateral. Lien searches can also uncover issues that a Borrower may have with suppliers or service providers and may serve as good intelligence regarding the Borrower's operations.

To be certain that the Energy Lender has performed adequate searches, it is important to understand the UCC rules regarding where to file evidence of liens against the Borrower. Except for fixture filings and other real-estate-related collateral, perfection of a security interest is generally achieved by filing a financing statement in the central filing office in the state where the debtor is "located":²

- (1) The following are "located," for these purposes, where the debtor is organized: corporation, LLC, LP, and Statutory Business Trust.
 - a. Except as otherwise provided in Texas Business and Commerce Code § 9.307, 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.³
 - b. A registered organization is located in the state where it is physically located.⁴ A "registered organization" is organized solely under the laws of a single state or of the United States and as to which the state or the United States must maintain a public record showing the organization to have been organized.⁵
- (2) A general partnership or common law trust is located in the state in which the debtor has its place of business. If the general partnership or common law trust has more than one office, it is located where its chief executive officer is physically located.⁶
- (3) An individual is located in the state of the debtor's principal residence.⁷
- (4) A foreign organization is located in the country in which its chief executive office is physically located if that country has a public filing system permitting a secured party, who files in accordance with that system for the relevant collateral, to prevail over a subsequent lien creditor. If there is no such system, the foreign debtor is deemed to be located in the District of Columbia.⁸

The local laws of the jurisdiction in which the wellhead or minehead is located govern perfection, the effect of perfection or nonperfection,

2. TEX. BUS. & COM. CODE ANN. § 9.301 (West 2013).

3. *Id.* § 9.301(1).

4. *Id.* § 9.307(e).

5. *Id.* § 9.102(71).

6. *Id.* § 9.307.

7. *Id.*

8. *Id.*

and the priority of a security interest in as-extracted collateral.⁹ The local laws of the jurisdiction in which the Borrower's property is located determine the perfection, the effect of perfection or nonperfection, and the priority of a security interest in fixtures. As for a lien against the oil and gas that is in the ground and considered to be a part of the mineral estate, Texas law requires that a deed of trust be filed in the county where the property is located in order to have a lien against the oil and gas.¹⁰

In a traditional, one-borrower, oil and gas loan transaction, the Energy Lender typically runs searches in the following places:

- A UCC lien search against the Secretary of State's UCC records in the jurisdiction where the Borrower is organized;
- A UCC/fixture filing search in each county where the Borrower's oil and gas property collateral is located; and
- A search of the deed records where the Borrower's oil and gas property collateral is located.

In addition to lien searches, the Energy Lender's counsel is often asked to run searches to uncover tax liens and litigation. These searches should always be conducted in the counties where the collateral is located (as often, the dispute will resolve the oil and gas company's property), in the county the headquarters of the company are located, and in other substantial operational areas of the Borrower.

3. Preparation of Deed of Trust Exhibits and the Mortgage Test Covenant

The amount that the Energy Lender is willing to lend to the Borrower varies with the value of the properties in the borrowing base.¹¹ The Credit Agreement will have a covenant that a certain percentage of the value of the properties in the borrowing base be under mortgage; it is normally a high percentage but not always 100%. It is not always 100% because the Borrower wants to be able to borrow money based on its full income stream as well as its undeveloped but promising properties but does not necessarily want to pledge all of the assets that contribute to that income stream because, often, the Borrower will own nominal properties in non-core areas, and it is not worth the Borrower's time or expense to file mortgages in non-core areas. This is particularly true if the Borrower owns non-core properties in other states. Additionally, if the percentage is less than 100%, it allows the Borrower to have a nominal error in preparing the exhibits to the mortgages without being in default under the Credit Agreement.

9. *Id.* § 9.301(d).

10. TEX. PROP. CODE ANN. § 13.001 (West 2013).

11. The borrowing base sets how much money the Energy Lender is willing to lend to the Borrower at any given time.

In setting the amount that can be borrowed under the loan at the closing of the loan, the Energy Lender will make a determination usually based on a reserve report.¹² Once the borrowing base is set and each individual property is assessed a value, the Energy Lender's counsel assists in choosing which properties will be mortgaged in order to reach the mortgage test amount.

Upon identifying the set of properties that will be mortgaged (in some cases, this would be all the properties on the reserve report), the Energy Lender's counsel will often work together with the Borrower's land personnel to create the exhibits to the deeds of trust. It is industry practice in Texas for the deed of trust exhibit to be a schedule of the leases that correspond to the set of properties that will be mortgaged.

The Energy Lender and the Energy Lender's counsel often rely solely on the land work of the Borrower to ensure that the correct oil and gas leases are mortgaged because the reserve report will usually have only the names of the wells and potential wells, along with American Petroleum Institute (API) numbers for the drilled or soon-to-be drilled locations. The reserve reports typically do not have legal descriptions or lease schedules for the properties listed (and even if they did, they would not be certified statements of the locations). As such, the group of mortgaged properties from the reserve report is sent to the land department, and the land department begins matching leases to the properties based on its records. In numerous instances the land department has had some difficulty in doing this correlation or explaining how it did its correlation in a logical way when it offered the lease schedule for review. The land department and the engineering department seem to be using different names for wells and prospects, and the land department may not have its files organized the same way that the engineering department groups together properties.

It is possible for the Energy Lender and its counsel to do a correlation based on records not provided to them by the Borrower, but it is rarely done. For example, a reserve report contains a proved developed producing property called the Maxwell #1, and it is valued at \$2.5 MM on the reserve report. Each time a new well is drilled in the State of Texas, an oil and gas company must submit a plat that shows the location of the well.¹³ So, the Energy Lender could obtain the plat for the Maxwell #1 well from the Railroad Commission records. Additionally, the Borrower's land department has provided the Energy Lender with a schedule of leases that cover the Maxwell #1. By taking the legal description from the leases (and where necessary, any unit

12. To the extent that the preparation of a reserve report is impracticable or not feasible given the Borrower's holdings, the Energy Lender may make such evaluations based on revenue runs and lend on a percentage of the historical revenues.

13. 16 TEX. ADMIN. CODE ANN. § 3.5 (West 2013).

designations for the Maxwell #1), the Energy Lender could determine if the leases that the Borrower purports to cover the Maxwell #1.

But this process is time-draining, tedious, and not conducive to the typical, fast-paced lending transaction. For example, assume that the lease schedule for the Maxwell #1 has four leases, but none of the metes and bounds descriptions of the lands covered by the leases, but instead just refers to the lands covered by the leases. So, the land department for the Borrower would need to pull the four leases and distribute those to the Energy Lender (or the Lender could request those from the county records). The legal descriptions of the lands covered by the leases refer to descriptions of four different deeds. The land department has three of the four deeds in its land files but needs to request the fourth deed from the county records. Two of the three deeds that the land department does have refer to other deeds that are not in the land department's records, so the land department needs to request those from the county. One of the deeds does have a metes and bounds description, so the Energy Lender's counsel can have one of its paralegals begin work on charting the legal description against the plat filed with the Railroad Commission. However, the plat filed with the Railroad Commission contains a different name than the metes and bounds description in the deed. So, the real estate paralegal must send for more records from an abstract company in the county where the Maxwell #1 is located. In short, this process can become highly involved.

The correlation of one well to the lease records most likely would not have this many different problems, but even one of those issues showing up in one of those properties in a loan deal with 100 or more properties could drastically slow down the progress of getting a deal done. As such, the Energy Lender is normally willing to forego this process and rely on the land department's correlation. The risk with doing so is that in a bankruptcy of the Borrower, the Energy Lender could face the reality of not having mortgages on the appropriate leases related to the set of properties that were supposed to be mortgaged. This risk can be mitigated by careful work on the title test and by making sure that the title work that the Energy Lender receives is used to confirm the lease schedules that will be attached to the deeds of trust.¹⁴ In addition, to the extent that the Energy Lender does not receive title work for a group of the borrowing base properties, the Energy Lender could pick certain high-valued properties and conduct additional diligence on these properties to confirm the land department's correlation.

To make sure that the requisite information has been placed on the mortgage exhibit, there must be a sufficient description of the land

14. *See supra* Part I.A.4.

that would allow a person familiar with the area to locate the land.¹⁵ In Texas, it is sufficient for a deed to refer to a legal description in another previously recorded deed.¹⁶ Based on the foregoing, it has become industry practice for the Energy Lender to list only a schedule of the oil and gas leases for the property being mortgaged, and the lease schedule, which will include the names of the Lessor and Lessee, the date of the lease, the recordation date of the lease, and the recording information of the lease (or the lease memorandum as applicable).

4. Title Test Representation and Covenant

For good reason, the Energy Lender wants to know that the Borrower has good title to the properties that are collateral for the loan. Likewise, the Borrower does not want to pay for the Energy Lender to review title for all of the properties on the reserve report; nor does the Borrower want to go through the process of proving its title to all the properties. As such, the Borrower will attempt to negotiate that the Energy Lender be “satisfied” (normally in Lender’s sole discretion) with a percentage of the value of the properties on the reserve report, as opposed to all of the properties on the reserve report. This percentage is normally a term-sheet item and is negotiated. The market number due to the negotiation process normally ranges between 60–90% of the value of the properties on the reserve report. The Borrower will be required to show this title test compliance as of the date of the closing of the loan and on-going basis.

Upon setting the threshold number, the Borrower will provide, to the Energy Lender and its counsel, evidence that the Borrower has good title to its property. Sometimes the Energy Lender will require that mortgage title opinion be written to bring forward division order title opinions for producing properties. Other times the Energy Lender will accept division order title opinions updated by landman runsheets, the Energy Lender will rely on division order title opinions only, or a hybrid approach will be developed, with more requirements being placed on the higher-valued properties.

The Energy Lender’s counsel has a tall task helping the Energy Lender and the Borrower through this process. First, division order title opinions come in different sizes and shapes—with some seeing curative requirements that others may not see—and others using a different set of assumptions. Additionally, some division order title opinions will be written, giving the Borrower requirements related to curative items. However, the Borrower may not have the title opinion supplemented after the Borrower takes care of the curative items, or the Borrower may not have addressed all of the requirements and decided to take the business risk that the potential title issue will not

15. *Gates v. Asher*, 280 S.W.2d 247, 248–49 (Tex. 1955).

16. *Pick v. Bartel*, 659 S.W.2d 636, 637 (Tex. 1983).

become an issue. The difficulty for the Energy Lender's counsel will be trying to succinctly relate the issues related to each of the individual properties being reviewed for the title test and putting the Energy Lender in a place to determine whether title is satisfactory to the Energy Lender.

The Energy Lender's counsel is well-served to work with the Energy Lender at the outset to determine if certain unfulfilled requirements or opinions with certain unsavory assumptions will still fall into the "satisfactory" category. Furthermore, to the extent that the Energy Lender is making a loan on multiple properties, but the value of the properties is mainly wrapped up in a few select properties, the Energy Lender's counsel might suggest a different level of satisfaction on those properties compared to that of lesser-valued properties.

Ultimately, a thorough presentation by the land department of the Borrower related to title will aid the Energy Lender's counsel and the timely completion of an energy lending transaction. A piecemeal distribution of opinions with no information regarding which opinion relates to which properties on the reserve report will have the opposite effect. However, the Borrower's land department is often taxed to make a good presentation because the land department will be at full utilization prior to the lending transaction, and there will not be adequate resources to make such a presentation in light of the time demands in completing the transaction. This reality may cause the evaluation of the title to the reserve report properties to become a post-closing item, as the rest of the transaction can outpace the title review process.

It should be noted that information extracted from the title review should be used to verify the exhibits to the deed of trust to verify that the Borrower has provided all of the leases that related to a particular property on the reserve report.

B. Due Diligence from the Borrower's Perspective

The Borrower wants the money immediately after it signs the term sheet. The Borrower's counsel needs to make sure that the Borrower engages the appropriate individuals in anticipation of the requests that will come from the Energy Lender and the Energy Lender's counsel, even before receiving the first draft of the credit agreement. For example, the land department must prepare the schedule of leases for the mortgages. Moreover, the Borrower's counsel must confirm that the Borrower has adequately prepared the disclosure schedules to give the proper qualifications to the representations and warranties in the credit agreement. Frequently, the Borrower's counsel must prepare the disclosure schedules with the cooperation of different segments of the Borrower's personnel.

II. SECURING THE COLLATERAL FOR THE LOAN

The life of an oil and gas molecule is one of transition. To account for this transition, the Energy Lender's counsel must carefully evaluate each life cycle of the molecule and the contracts and equipment that assist in turning the oil and gas into money and be sure that the Energy Lender's counsel has perfected security interests in each stage of this transition.

A. *Oil and Gas in the Ground*

Prior to the oil and gas coming from the ground, it is part of the mineral estate, which is considered under Texas law to be real property.¹⁷ This is true regardless of whether the minerals are subject to an oil and gas lease, as oil and gas leases are considered to convey an interest in real estate.¹⁸ In Texas, in order to obtain a security interest in real estate that can (i) be foreclosed upon and (ii) give priority over other claims to, or conveyances of, the oil and gas in the ground, the Energy Lender must file a deed of trust in each county where the oil and gas properties serving as collateral are located.¹⁹ Typical deeds of trust will contain both (i) granting language like a deed in order to give the Energy Lender rights to the mineral estate upon an event of default of the credit agreement and (ii) a grant of a security interest in any personal property that is related to the oil and gas in the ground.

B. *Oil and Gas After Extraction*

1. What Type of Collateral Is It?

As the oil and gas comes out of the ground subject to a deed of trust, it ceases to be part of the mineral estate and instead becomes both a "good"²⁰ and "as-extracted collateral" under the Texas Uni-

17. *Stephens Cnty. v. Mid-Kan. Oil & Gas Co.*, 254 S.W. 290 (Tex. 1923).

18. *Id.*

19. See generally TEX. PROP. CODE ANN. §§ 13.001, 51.001 (West 2013).

20. A "good" is defined as:

all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also includes a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction.

form Commercial Code definitions. “As-extracted collateral” is defined as:

- (1) oil, gas, or other minerals that are subject to a security interest that:
 - a. Is created by a debtor having an interest in the minerals before extraction; and
 - b. Attaches to the minerals as extracted; or
- (2) accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which the debtor has an interest before extraction.²¹

2. Attachment

The following is required to establish an enforceable security interest against goods or as-extracted collateral:

- (1) Value has been given;
- (2) The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and
- (3) The debtor has signed a security agreement (or has possession or control with respect to other interests such as deposit accounts, certificated securities, or letter-of-credit rights, etc.).²²

However, for as-extracted collateral, there is an additional way to have an enforceable security interest, specifically:

If a secured party holds a security interest that applies under this chapter to minerals, including oil and gas, upon their extraction and the security interest also qualifies under applicable law as a lien on those minerals before their extraction, the security interest before and after production is a single continuous and uninterrupted lien on the property. This subsection is a statement of the law of this state as it existed before the effective date of this subsection and applies with respect to minerals, including oil and gas, regardless of when the minerals were extracted.²³

This meaning seems clear even though the new term as-extracted collateral was not used. The note provided by the State Bar of Texas explains that the intention of the change is to adopt the concept that, when the mortgage lien and the UCC lien are both created in the same writing and that writing was filed so as to perfect both the real property mortgage and the UCC security interest, the result is the cre-

TEX. BUS. & COM. CODE ANN. § 9.102(a)(44) (West 2013).

21. *Id.* § 9.102(6).

22. *Id.* § 9.203(b)(1)–(3).

23. *Id.* § 9.203(j).

ation of a single continuous security interest that attaches while the minerals are in the ground and continues after extraction.²⁴

3. Perfection

For oil and gas that is located in Texas, the laws of Texas govern perfection.²⁵ In order to perfect its security interest against goods and as-extracted collateral, the Energy Lender must make a filing. Goods require filing a financing statement at the Secretary of State's office to file by perfection,²⁶ but if a good is also as-extracted collateral, the Energy Lender must make the appropriate filing for as-extracted collateral.²⁷ As such, as-extracted collateral is perfected by making a filing in the county where a mortgage would be recorded against the mineral interest.²⁸ The filing must contain all of the following:

- (1) Name of the debtor;
- (2) Name of the secured party;
- (3) Indication that as-extracted collateral is to be covered;
- (4) Indication that financing statement is to be filed in the real property records;
- (5) Legal description of property sufficient for "constructive notice"; and
- (6) If the debtor does not have an interest in the real property of record, the name of such real property owner.²⁹

While the Energy Lender can file a UCC Financing Statement³⁰ in the county where a mortgage would be recorded to perfect its security interest, the Energy Lender can also utilize its mortgage to serve as an effective filing against as-extracted collateral.³¹ In order for the mortgage to serve this dual role, it must contain all of the following:

- (1) All of the information set forth in (1)–(6) above;
- (2) Indication of the goods or accounts that it covers; and
- (3) Indication that the collateral it covers is related to the real property described in the mortgage and is as-extracted collateral.³²

24. *See id.* § 9.203 (state bar committee comment).

25. *Id.* § 9.301(4).

26. *See id.* § 9.310(a).

27. *Id.* § 9.502(b).

28. *Id.* § 9.501(a)(1)(A).

29. *Id.* § 9.502(a)–(b). To the extent that minerals are owned of record by a different entity than the party pledging the as-extracted collateral, the filing must be indexed under both the debtor's name and the record interest owner's name. *Id.* § 9.519(d).

30. Still usually referred to as a UCC-1 despite the change in nomenclature introduced in 2002.

31. *Id.* § 9.502(c).

32. *Id.*

Despite the clear language that a mortgage suffices in order to perfect against as-extracted collateral, many transactional attorneys insist on filing both a deed of trust and a financing statement in the county records to ensure that as-extracted collateral is covered. They do this because of fear that a court rules that the deed of trust or the UCC Financing Statement is lacking something that would render it ineffective. A continuation statement is required with respect to mortgages filed as financing statements covering as-extracted collateral just like it would be for the filing of a UCC Financing Statement.³³

4. Priority

While the Texas UCC contains special rules for the perfection of as-extracted collateral, there are no special rules regarding how the priority of competing claims in as-extracted collateral are solved. Consequently, oil and gas that has been extracted, but not yet sold and turned into an account, is governed by the priority rules for goods. Common non-exhaustive rules regarding the priority of competing claimants are:

- (1) *Secured Party v. Secured Party*—If two secured parties make a claim to the same good, the secured party that first perfects or files financing statement has priority over the other secured party;³⁴
- (2) *Secured Party v. Lien Creditor*—If a secured party and a lien creditor make a claim to the same good, the secured party wins if it perfected its security interest or merely met one of the requirements for attachments and filed a financing statement prior to the lien creditor becoming a lien creditor;³⁵
- (3) *Secured Party v. Buyer*—If a secured party and a buyer of a good both make a claim to such good, the secured party will generally have the superior priority.³⁶ However, if the secured party authorized the disposition to a buyer, the buyer will win the claim.³⁷ Additionally, if the buyer is a “buyer in the ordinary course,” the buyer’s claim will trump the secured party’s claim if the buyer has no knowledge that the secured party has a security agreement in place (and the buyer has no obligation to search for such an agreement).³⁸

33. *Id.* § 9.515(g).

34. *Id.* § 9.317(a)(1).

35. *Id.* § 9.317(a)(2)(A)–(B).

36. *Id.* §§ 9.201, 9.315(a)(1).

37. *Id.* § 9.315(a).

38. *Id.* § 9.320(a). According to the Texas Business & Commerce Code, a “Buyer in the ordinary course” is:

a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of

C. Oil and Gas after It Is Sold

1. What Type of Collateral Is It?

Once oil and gas is sold, the Borrower owns an account,³⁹ as-extracted collateral, and proceeds⁴⁰ until the Borrower receives money, and then the Energy Lender's collateral is considered to only be proceeds.⁴¹

that kind. A person buys goods in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices. *A person that sells oil, gas, or other minerals at the wellhead or minehead is a person in the business of selling goods of that kind.* A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale. Only a buyer that takes possession of the goods or has a right to recover the goods from the seller under Chapter 2 may be a buyer in ordinary course of business. "Buyer in ordinary course of business" does not include a person that acquires goods in a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

Id. § 1.201(9) (emphasis added).

39. "Account,"

except as used in 'account for,' means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a state, governmental unit of a state, or person licensed or authorized to operate the game by a state or governmental unit of a state. The term includes health-care-insurance receivables. The term does not include (i) rights to payment evidenced by chattel paper or an instrument, (ii) commercial tort claims, (iii) deposit accounts, (iv) investment property, (v) letter-of-credit rights or letters of credit, or (vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.

Id. § 9.102(a)(2).

40. "Proceeds," except as used in Section 9.609(b), means the following property:

- (A) Whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
- (B) Whatever is collected on, or distributed on account of, collateral;
- (C) Rights arising out of collateral;
- (D) To the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to the collateral; or
- (E) To the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to the collateral.

Id. § 9.102(a)(65).

41. *See id.*

2. Perfection

In order to perfect against an account or as-extracted collateral, a secured party must make a filing. To perfect against an account, the Energy Lender would file a financing statement with the Texas Secretary of State.⁴² However, since this particular account is also as-extracted collateral, the rules for filing for as-extracted collateral must be followed under Texas UCC § 9.502(b).⁴³ Upon a purchaser of the production paying the account, the collateral is neither an account nor as-extracted collateral but instead proceeds of both. Proceeds are perfected if the original collateral was perfected,⁴⁴ and perfection over identifiable cash proceeds continues indefinitely.⁴⁵

3. Priority

As noted above, there are no special rules regarding how the priority of competing claims in as-extracted collateral are solved. As such, oil and gas that has been extracted and turned into accounts is governed by the priority rules for accounts until cash comes in and then by the rules for proceeds.

Common non-exhaustive rules regarding the priority of competing claimants of accounts are:

- (1) *Secured Party v. Secured Party*—If two secured parties make a claim to the same account, then the first secured party who perfects its security interest has priority over the other secured party;⁴⁶
- (2) *Secured Party v. Lien Creditor*—If a secured party and a lien creditor make a claim to the same account, the secured party wins if it perfected its security interest or merely met one of the requirements for attachments and filed a financing statement *prior to* the lien creditor becoming a lien creditor;⁴⁷
- (3) *Secured Party v. Buyer*—If a secured party and a buyer of an account both make a claim to such account, the buyer will have the superior priority only in the event that the buyer gave value for the account, did not have knowledge of the secured party's security interest, and made the purchase prior to the perfection of the secured party's interest.⁴⁸

42. *Id.* § 9.310(a).

43. *Id.* § 9.502(b); *see supra* Part II.B.3 for the rules on filing properly for as-extracted collateral.

44. Bus. & Com. § 9.315(c).

45. *Id.* § 9.315(d)(2).

46. *Id.* § 9.322(a).

47. *Id.* § 9.317(a)(2)(A)–(B).

48. *Id.* § 9.317(d).

Common non-exhaustive rules regarding the priority of competing claimants of proceeds once an account is turned to cash are:

- (1) *Secured Party v. Secured Party*—Generally, if two secured parties make a claim to the same proceeds, then the first secured party who perfects or files its security interest has priority over the other secured party.⁴⁹ However, in the event cash is deposited into a deposit account, and one of the secured parties has control over that deposit account and the other secured party has merely filed against collateral that turned into cash, then the secured party with control over the account will be given priority, regardless of when the other party may have filed;⁵⁰
- (2) *Secured Party v. Lien Creditor*—If a secured party and a lien creditor make a claim to the same proceeds, then the secured party wins if it perfected its security interest or merely met one of the requirements for attachments and filed a financing statement *prior to* the lien creditor becoming a lien creditor;⁵¹
- (3) *Secured Party v. Buyer*—If a secured party and a buyer of an account both make a claim to proceeds, then the buyer will have the superior priority only in the event that the buyer gave value for the account, did not have knowledge of the secured party's security interest and made the purchase prior to the perfection of the secured party's interest.⁵²

D. *Equipment*

1. What Constitutes Equipment?

“Equipment” means goods other than inventory,⁵³ farm products, or consumer goods.

2. Perfection

Equipment, like all goods, can be perfected by either filing or taking possession.⁵⁴ However, particularly with equipment, it should be noted that state and federal laws might preempt the process of estab-

49. *Id.* § 9.322(a).

50. *Id.* § 9.327.

51. *Id.* § 9.317(a)(2)(A)–(B).

52. *Id.* § 9.317(d).

53. “Inventory” means goods, other than farm products, that:

(A) Are leased by a person as lessor;

(B) Are held by a person for sale or lease or to be furnished under a contract of service;

(C) Are furnished by a person under a contract of service; or

(D) Consist of raw materials, work in process, or materials used or consumed in a business.

Id. § 9.102(a)(62).

54. *Id.* §§ 9.310(a), 9.313(a).

lishing a lien against equipment.⁵⁵ For example, Texas law requires that evidence of a lien against a vehicle's title be notated on the certificate of title.⁵⁶

3. Priority

The priority for equipment is the same as the priority for oil and gas after extraction as set forth in Part III.B.4 of this Article.

E. *Fixtures*

1. What Is a Fixture?

"Fixtures" means goods that have become so related to particular real property that interest in them arises under the real property law of the state in which the real property is situated.⁵⁷ Almost nothing becomes a part of the real estate when it involves the oil and gas industry in Texas.

2. Perfection

A security interest against fixtures is perfected through a filing in the county records where the fixtures are located.⁵⁸ Like as-extracted collateral, the Energy Lender can perfect its lien against fixtures by having the deed of trust filed in that county cover fixtures or by filing a U.C.C. Financing Statement in that county.⁵⁹ Despite the clear language that a mortgage suffices in order to perfect against fixtures, many transactional attorneys insist on filing both a deed of trust and a financing statement in the county records to insure that fixtures are covered because of fear that a court rules that the deed of trust or the U.C.C. Financing Statement is lacking something that would render it ineffective.

3. Priority

- (1) *Secured Party v. Secured Party*—If two secured parties make a claim to the same fixture, the first secured party who perfects or files its security interest has priority over the other secured party;⁶⁰
- (2) *Secured Party v. Owner of the Real Estate*—If a secured party and the owner of the real estate make a claim to the same fixture, the general rule is that the owner of the real estate's claim to the fixture is superior to the secured party's claim. However, in the event that the real estate owner has authorized the re-

55. *Id.* § 9.311(a).

56. TEX. TRANSP. CODE ANN. § 501 (West 2013).

57. BUS. & COM. § 9.102(a)(41).

58. *Id.* § 9.501(a)(1)(B).

59. *Id.* § 9.502(b)–(c).

60. *Id.* § 9.322(a).

removal of the fixtures or disclaimed an interest in the fixtures, then the secured party will have priority over the real estate owner;⁶¹

- (3) *Secured Party v. Buyer*—If a secured party and a buyer of a fixture both make a claim to the fixture, then the priority treatment is the same as a secured party versus a buyer as oil and gas after it has been extracted as set forth in Part II.B.4 of this Article.⁶²

61. *Id.* § 9.334(f). Note that § 9.334 contains other situations where the secured party will have priority over the owners of the real estate.

62. *Id.* §§ 9.201, 9.315(a)(1).