Report of the ABA UCC Committee Task Force on Oil and Gas Finance

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# REPORT OF THE ABA UCC COMMITTEE TASK FORCE ON OIL AND GAS FINANCE

_by Alvin C. Harrell* and Owen L. Anderson**_

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The authors gratefully acknowledge the extensive assistance provided by Professor Frederick H. Miller, George L. Cross Research Professor & Kenneth McAfee Centennial Professor, The University of Oklahoma College of Law. Professor Miller is also a member of the UCC Committee Task Force.

Other members of the UCC Committee Task Force are listed at the end of this Article.
I. INTRODUCTION

In 1990 the Permanent Editorial Board ("PEB") for the Uniform Commercial Code ("UCC") established a study group (the "PEB Study Group") to consider the possible need for revision of UCC Article 9. Article 9 governs security interests in personal property and has been enacted in some form in all fifty states. On December 1, 1992, the PEB Study Group issued its report recommending in general terms a series of revisions to Article 9. The PEB Study Group Report recommended the formation of a drafting committee to prepare specific revisions to Article 9. Such a committee was subsequently formed, with Professors Steven L. Harris and Charles W. Mooney serving as the Reporters. It should be emphasized that the PEB Report is stated in general terms (though it focuses on specific issues) and that it is only a recommendation.

In the Spring of 1991, the Uniform Commercial Code Committee of the Section of Business Law of the American Bar Association established a Task Force on Oil and Gas Finance ("Task Force") for the purpose of studying the treatment of oil and gas under UCC Article 9. The Task Force was directed to report initially to the PEB Study Group, and subsequently to the Article 9 Drafting Committee. The Task Force was directed to study the Article 9 provisions relating to oil and gas collateral and to recommend possible changes to be incorporated in the proposed Article 9 amendments.

1. Both the UCC and the PEB are jointly sponsored by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") and the American Law Institute ("ALI"). See generally, Richard E. Coulson, The National Conference of Commissioners on Uniform State Laws and the Control of Law-Making — A Historical Essay, 16 OKLA. CITY U. L. REV. 295 (1991) (discussing the goal of uniformity); Marianne B. Culhane, The UCC Revision Process: Legislation You Should See in the Making, 26 CREIGHTON L. REV. 29 (1992) (outlining the drafting process of the UCC); Fred H. Miller, Status Report: Updating Commercial Law, 44 CONSUMER FIN. L.Q. REP. 282 (1990) (recognizing that the PEB was given the responsibility of modernizing and improving the UCC); Fred H. Miller, Thumbnail Sketch of The New Uniform Commercial Code, 46 CONSUMER FIN. L.Q. REP. 81 (1992) (expecting recommendations to Article 1 to be endorsed by the PEB and then eventually worked into future revisions of the UCC); Fred H. Miller, The Uniform Article 2A Amendments and the National Conference of Commissioners on Uniform State Laws After One Hundred Years, 45 CONSUMER FIN. L.Q. REP. 193 (1991) (noting the approval of the PEB and the ALI of the NCCUSL's 1990 adoption of amendments to Article 2A).

2. See Fred H. Miller, The Revision of UCC Article 9, 47 CONSUMER FIN. L.Q. REP. 257 (1993). Copies of the full report may be obtained from:
   Order Department
   The American Law Institute
   4025 Chestnut Street
   Philadelphia, PA 19104-3099.


4. The chair is William M. Burke of California.
The Task Force membership includes approximately twenty lawyers and academics from five oil and gas producing states. For the past three years the Task Force has been studying the case law interpreting Article 9 in the context of oil and gas transactions. After reviewing a number of drafts, an initial report was delivered to the Article 9 Study Group in 1992. As revised, the Final Report was submitted to the Article 9 Drafting Committee in 1994, reflecting subsequent comments by interested parties. During this process, members of the Task Force met with the Article 9 Study Group and later, the Article 9 Drafting Committee, as well as with groups of oil and gas lawyers in Louisiana, Oklahoma, and Texas, to discuss the proposed Article 9 revisions relating to oil and gas finance. The recommendations of the Task Force Report were incorporated in the initial report of the PEB Study Group issued December 1, 1992, and the Task Force is continuing to work with the subsequently appointed Article 9 Drafting Committee as the revision project continues.

The proposed revisions will undoubtedly evolve during the drafting process with some being rejected, some changed, and others added, and therefore, the revisions represent (in Professor Fred Miller’s words) a “moving target.” Therefore, the recommendations in the PEB Report and the analysis in the Task Force Report are already to some extent obsolete. Nonetheless, this article will help alert interested parties to the thrust of the recommended changes, so as to encourage such parties to provide desired input as the revision process continues. In addition, in many instances the recommendations in the Report represent a clarification of the current statute and therefore may be useful to parties analyzing these issues under existing law.

The Task Force considered recommendations for possible revision of UCC Article 9 with regard to four types of oil and gas related collateral: (1) minerals in the ground, (2) extracted minerals, (3) related contractual rights, and (4) vehicles and equipment. The conclusions and recommendations of the Task Force are described below.

II. OVERVIEW OF THE TASK FORCE REPORT

A. Minerals in the Ground and Extracted Minerals

From the beginning, the Task Force recognized the necessity of treating minerals in the ground as real property. In regard to extracted minerals, the

5. Comments may be sent to the Reporters or to:
   Michael Greenwald, Esq.
   The American Law Institute
   4025 Chestnut Street
   Philadelphia, PA 19104-3099.
Task Force position evolved somewhat over the course of its study, from an initial position favoring treatment of all extracted minerals as ordinary goods (subject to central filing in the UCC records), to a position reflecting deference to real property concepts for perfection of security interests, created by mortgage or otherwise, that attach to minerals being extracted. As a consequence, the Task Force Report favors perfection of a security interest that attaches to minerals as they are extracted by recording a mortgage or filing a financing statement (with a legal description) in the real estate records of the county where the well is located. Essentially this follows the pattern of the current Oklahoma and Texas non-uniform versions of Article 9.

It should be emphasized that the Report recommends treating oil and gas after extraction as personal property subject to Article 9 for all purposes; the Report merely recommends creating (or clarifying) a special filing rule at Section 9-401 for minerals that become subject to a security interest upon extraction. A security interest that attaches to minerals after extraction would continue to be perfected only by a central filing in the UCC records, as for ordinary goods. The Task Force believes that these two types of security interests in extracted minerals are not likely to conflict due to the difficulty of tracing extracted oil and gas, the impact of Section 9-307 (which cuts off a security interest upon a sale of goods to a buyer in the ordinary course of business, including most sales of oil and gas at the wellhead), and other proposed changes noted infra in this Report.

The Report thus recommends continuing (but clarifying) the current division of minerals into three categories, with a different perfection rule for each: (1) minerals in the ground (subject to real estate mortgage law); (2) minerals being extracted (subject to a real estate mortgage or a UCC filing in the local real estate records); and (3) minerals after extraction (subject only to a central UCC filing).

The Report also recommends revision of UCC Section 9-307(1), to include real estate liens (e.g., a real estate mortgagee) created by the seller of oil and gas production within the interests that are cut off by a sale of minerals at the wellhead or mine to a buyer in the ordinary course of business. The Task Force concluded that real estate liens are sufficiently

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6. See U.C.C. § 1-201(9) (1990): "All persons who sell minerals or the like (including oil and gas) at wellhead or minehead shall be deemed to be persons in the business of selling goods of that kind" for purposes of the definition of a "buyer in the ordinary course of business." See U.C.C. § 9-307 (1) (1990). The Uniform Commercial Code will be referred to in the text as "UCC" or "the Code." All UCC citations are references to the 1990 Uniform Text unless otherwise noted.

7. UCC § 9-307(1) provides: "A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the buyer knows of its existence." U.C.C. § 9-307(1).

8. Id. Cf. In re Pullop, 6 F.3d 422 (7th Cir. 1993), aff'd 133 B.R. 627 (S.D. Ill. 1991) (placing mortgagee's claim to oil and gas production under mortgage "rents and profits" clause). See infra parts
protected by their claim to proceeds of the sale and by their ability to claim and control the remaining reserves in the ground (and hence, future production), and therefore have no need to claim extracted minerals. This resolves a significant potential conflict between real and personal property law. In addition, the primacy of a buyer in the ordinary course is widely recognized throughout the UCC and in other law.

The Task Force also recommends that the term “extracted minerals” be defined to include minerals that have been extracted but are being stored underground (e.g., natural gas). “Minerals in the ground” would be specifically defined to exclude such minerals. The Report also recommends: (1) that the proposed filing rule for perfection as to oil and gas production (requiring a filing in the real estate records) require that a description of the real estate be included in the description of the collateral (as is currently the case under Sections 9-402(1) and (5) and 9-103(5)); and (2) that the

III, IV.

9. UCC § 9-402 provides in part:

(1) A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral. A financing statement may be filed before a security agreement is made or a security interest otherwise attaches. When the financing statement covers crops growing or to be grown, the statement must also contain a description of the real estate concerned. When the financing statement covers timber to be cut or covering minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, the statement must also comply with subsection (5). A copy of the security agreement is sufficient as a financing statement if it contains the above information and is signed by the debtor. A carbon, photographic or other reproduction of a security agreement of a financing statement is sufficient as a financing statement if the security agreement so provides or if the original has been filed in this state. . . .

(5) A financing statement covering timber to be cut or covering minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or a financing statement filed as a fixture filing (Section 9-313) where the debtor is not a transmitting utility, must show that it covers this type of collateral, must recite that it is to be filed [for record] in the real estate records, and the financing statement must contain a description of the real estate [sufficient if it were contained in a mortgage of the real estate to give constructive notice of the mortgage under the law of this state]. If the debtor does not have an interest of record in the real estate, the financing statement must show the name of a record owner.

U.C.C. §§ 9-402(1), (5).

10. UCC § 9-103(5) provides:

(5) Minerals.

Perfection and the effect of perfection or non-perfection of a security interest which is created by a debtor who has an interest in minerals or the like (including oil and gas) before extraction and which attaches thereto as extracted, or which attaches to an account resulting from the sale thereof at the wellhead or minehead are governed by the law (including the conflict of laws rules) of the jurisdiction wherein the wellhead or minehead is located.

U.C.C. § 9-103(5).
proposed changes for oil and gas collateral be extended to cover other types of minerals as well.

B. Leases and Other Contractual Rights

Oil and gas leasehold interests are generally regarded as real property under non-Code law. The Task Force considered recommending that such interests be treated as personal property under Article 9, or alternatively that such characterizations continue to be determined under local, non-Code law, but rejected both positions in the interests of uniformity and simplicity. Instead, the Report recommends that leasehold and other specified interests (e.g., farmout agreements) should be characterized in Article 9 as real property, and hence specifically excluded from Article 9 under Section 9-104(j).\textsuperscript{11} Most other contractual interests (whether or not commonly viewed as contractual) would be classified as personal property. As explained \textit{infra}, the Task Force recommends that this distinction be maintained by specific reference to various types of interests as well as by a general descriptive rule relating to the nature of the interests involved.

C. Equipment and Vehicles

The Task Force concluded that oil and gas-related equipment and vehicles should be treated as personal property subject exclusively to the otherwise applicable rules of Article 9 or other state law. The Task Force considered but rejected the argument that some types of equipment should be considered fixtures, in part because such equipment normally is either removed or abandoned when the well is shut-in.

D. Statutory Liens and Realty Interests

The Task Force considered various ways to protect royalty owners without disrupting the Article 9 priority system. The Task Force concluded that a security interest granted by a working interest owner should not attach to the share of production attributable to royalty owners, and vice versa, whether such royalty is taken in value or in kind. Hence there should be no conflict between the proportionate claims of a royalty owner (e.g., under a state statutory lien law) and secured creditors of the working interest owners. At most any claim by a prior realty lien (e.g., the lessor's mortgagee) to production (or production proceeds) should be limited to that portion of

\begin{footnote}
\textsuperscript{11} UCC § 9-104 provides: “This Article does not apply . . . (j) except to the extent that provision is made for fixtures in Section 9-313, to the creation or transfer of an interest in or lien on real estate, including a lease or rents there under . . . .” U.C.C. § 9-104(j).
\end{footnote}
production attributable (whether in kind or in value) to the royalty owner and to the minerals remaining in the ground. The mortgagee's claim should not extend to personal property of the working interest owner such as the working interest owner's share of extracted oil and gas (whether stored on the premises or elsewhere) or oil and gas production equipment located on the property subject to the mortgage.

Working interest owners' secured creditors deserve protection from realty interests (including the claims of royalty owners and their mortgagees) in part because the ownership interests of working interest owners may be important as a means to secure their production loans, thereby making the project possible. Awarding priority to a lessee's mortgagee would amount to a windfall for that interest and might unduly discourage the financing of production projects. In any event, if the real estate mortgagee has not contractually subordinated its interest to the oil and gas lease the mortgagee can control future production by foreclosing the mortgage. If the mortgagee has subordinated, then the mortgagee has no claim to priority. Therefore, the Report proposes to give the working interest owners' secured creditors priority over realty claims as to all production attributable to the working interest owners, and as to all production and mining equipment on the property.

The Task Force proposes to achieve this result by clarifying that those purchasing a working interest owner's share of production qualify as a "buyer in the ordinary course of business" as to the working interest owner's net revenue interest share, so as to permit such parties' interests to pass free and clear of any prior realty lien. In conjunction with other recommendations noted infra, this would also limit the reach of state statutory mineral owners' liens to the production and proceeds attributable to the mineral owner, hence avoiding conflicts between such liens and any security interest covering the operator's interest or similar interests. Competing claims to identifiable but commingled production or proceeds would be governed by Section 9-315. Each of these issues is discussed more fully infra.

III. MINERALS IN THE GROUND AND THE IMPACT OF REAL PROPERTY LAW

Much oil and gas related collateral is of a hybrid nature in the sense that it has attributes that relate to both real and personal property. The Task Force concluded that the resulting conflicts between real and personal property lien law need to be resolved by Article 9 provisions that define the scope of the competing laws. The Report recommends resolution of these scope issues within Article 9. As noted supra, there is a consensus that minerals in the ground should continue to be recognized as real property and
consequently excluded from Article 9 under Section 9-104(j). This represents the overwhelming weight of authority and is too well imbedded in the fabric of the law to be changed now.

Unfortunately, this application of real property law complicates other issues that might otherwise be more easily solved solely within the basic structure of Article 9. The characterization of mineral interests as real property is the anchor that ties personal property oil and gas related collateral to real property law, creating a series of potential conflicts between real and personal property law that logically must be addressed within Article 9. One apparent and perhaps the only effective way to resolve these conflicts within Article 9 is by special filing rules for certain oil and gas collateral, patterned to some extent on the real property recording acts. This approach creates some inconsistency within Article 9 (as between the provisions applicable to certain oil and gas collateral versus other collateral) but should minimize the variations between states by providing a uniform approach within Article 9. This approach should also minimize uncertainties relating to the relative scope of real and personal property law.

In general, the approach recommended by the Task Force is to recognize that minerals in the ground are inherently real property and that some collateral associated with the extraction of those minerals (including contractual interests and extracted minerals to some extent) relates to the real property at the well or mine site in a unique way that must be accommodated within Article 9. Therefore, the Task Force Report makes two basic recommendations (discussed in more detail infra): (1) all equipment and other personal property used in mining and production should be treated as personal property, subject exclusively to Article 9 (and not real property law), but (2) mineral production itself relates to the real estate in ways that suggest a need for perfection by local filing in the real estate records of the county where the well or mine is located.

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12. See supra note 11.

IV. EXTRACTED MINERALS

The Task Force concluded that extracted minerals should be treated as personal property, in the form of goods, for purposes of Article 9.14 The Task Force recommends continued treatment of extracted oil and gas as personal property, subject to certain considerations relating to real property law.15 These considerations involve three matters: (1) the status of prior claims asserted under real property law, as against Article 9 security interests, (2) special filing rules relating to local real property recording acts, and (3) the categories of minerals recognized and the perfection requirements for each. These three matters will be discussed below.

A. Prior Claims Asserted Under Real Property Law

Because minerals constitute real property before extraction, under current law they and their proceeds may remain subject to claims established under real property law before the extraction, perhaps under a "rents and profits" clause in a real estate mortgage or under a state mineral owners' statutory lien law, despite the characterization of extracted minerals as personal property under Article 9.16 The Task Force recommends limiting the reach of these prior realty claims in two ways: (1) by expanding Section 9-307(1)17 to cut off prior real estate claims upon a sale of extracted minerals in the ordinary course of business, and (2) by utilizing Section 9-307(1) and other revisions to limit the scope of state mineral owners’ lien acts to the proportionate share of production, whether taken in kind or in value, attributable to the lessor/royalty owner or mortgagee, so as to preclude impairment of any security interest granted by the working interest

14. This reaffirms current law. See U.C.C. § 9-105(1)(h) (definition of "goods").
15. In contrast to statements in In re Fullop, 6 F.3d at 428-30, the Task Force believes that Article 9 should be the exclusive source of a security interest in oil and gas being produced, even in cases where perfection is achieved by recording a real estate mortgage pursuant to a provision such as nonuniform OKLA. STAT. tit. 12A § 9-402(5) (1985) (permitting perfection by real estate mortgage). While the Task Force Report would allow perfection of a security interest in oil and gas production by means of a real estate mortgage, it would recognize Article 9 as the exclusive source of the applicable law. Cf. 6 F.3d at 428-29, 431 (noting that Article 9 and a real estate mortgage "rents and profits" clause represent "two alternative routes" to a security interest in extracted minerals; "when a lien arises under a ... real estate mortgage, real property law provides the requirements for perfection, not Article 9."). See generally, HARRELL ET AL., supra note 13, at 282-85 (discussing the aspects of real property law with regard to extracted minerals); Cross & Curtis, supra note 13, § 11.06 (discussing the role of Article 9 and the use of mortgages and deeds of trust).
17. See supra note 7.
owners. As discussed infra, the Task Force also proposes restricting the ability of a realty interest to assert claims against other personal property associated with an oil and gas well.

B. Special Filing Rules for Extracted Minerals

UCC Sections 9-401, 9-402, and 9-403 provide special filing and perfection rules for "minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103." As illustrated by the district court decision in In re Fullop, this apparently requires reference to Section 9-103(5) (governing interstate choice of law issues) to determine the scope of the Article 9 Part 4 filing rules for minerals in intrastate transactions. Aside from the somewhat cumbersome nature of this arrangement, it suggests the possibility that the special Article 9 Part 4 filing rules for minerals might be limited to interstate choice of law cases (pursuant to Section 9-103(5)). The simple solution to this problem is to provide a self-contained filing rule in Section 9-401, without reference to Section 9-103(5). The next step would be to determine just what that rule should be.

C. Categories of Extracted Minerals

Currently, there are three separate categories of minerals recognized in Article 9, with a different filing system for each: (1) Minerals in the ground (excluded from Article 9 under Section 9-104(j)); (2) minerals subject to a security interest that attaches upon extraction (subject to perfection by a filing in the real estate records under Sections 9-103(5), 9-401(1), 9-402(1)

18. See infra parts IV.J., VII.
20. 133 B.R. 627 (S.D. Ill. 1991), aff'd, 6 F.3d 422 (7th Cir. 1993).
22. 133 B.R. at 634-35.
23. This is an argument that was made in Fullop and rejected by the district court. See id. at 638-39; infra notes 29, 33 and accompanying text.
24. See supra note 11.
26. UCC § 9-401(1) provides:
   (1) The proper place to file in order to perfect a security interest is as follows:
   (a) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded
   (b) in all other cases, in the office of the Secretary of State.
and (5), 27 and 9-403(7); 28 and (3) minerals subject to a security interest

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**Second Alternative Subsection (1)**

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is equipment used in farming operations, or farm products, or accounts or general intangibles arising from or relating to the sale of farm products by a farmer, or consumer goods, then in the office of the _____ in the county of the debtor's residence or if the debtor is not a resident of this state then in the office of the _____ in the county where the goods are kept, and in addition when the collateral is crops growing or to be grown in the office of the _____ in the county where the land is located;

(b) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;

(c) in all other cases, in the office of the [Secretary of State].

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**Third Alternative Subsection (1)**

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is equipment used in farming operations, or farm products, or accounts or general intangibles arising from or relating to the sale of farm products by a farmer, or consumer goods, then in the office of the _____ in the county of the debtor's residence or if the debtor is not a resident of this state then in the office of the _____ in the county where the goods are kept, and in addition when the collateral is crops growing or to be grown in the office of the _____ in the county where the land is located;

(b) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;

(c) in all other cases, in the office of the [Secretary of State] and in addition, if the debtor has a place of business in only one county of this state, also in the office of _____ of such county, or, if the debtor has no place of business in this state, but resides in the state, also in the office of _____ of the county in which he resides.

Note: One of the three alternatives should be selected as subsection (1).

U.C.C. § 9-401(1).

27. See supra note 9.

28. UCC § 9-403(7) provides:

(7) When a financing statement covers timber to be cut or covers minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or is filed as a fixture filing, [it shall be filed for record and] the filing officer shall index it under the names of the debtor and any owner of record shown on the financing statement in the same fashion as if they were the mortgagees in a mortgage of the real estate described, and, to the extent that the law of this state provides for indexing of mortgages under the name of the mortgagor, under the name of the secured party as if he were the mortgagor thereunder, or where indexing is by description in the same fashion as if the financing statement were a mortgage of the real estate.
which attaches after extraction (treated as ordinary goods, most likely inventory). The Task Force recommends retention and clarification of these categories, as discussed infra.

D. Impact of Non-Uniform Amendments

In some oil and gas producing states (notably Oklahoma and Texas), the confused relationship between real and personal property law led to enactment of non-uniform Article 9 provisions tying Article 9 perfection even more closely to the real estate recording acts (by bringing a wider range of oil-and gas-related personal property collateral within the scope of the special filing rules, and permitting perfection as to extensive classes of personal property by means of a real estate mortgage), apparently on the assumption that the real estate records would need to be utilized in any oil and gas production financing. In effect, the real estate records were recognized as a single repository for providing notice as to the real property and many personal property aspects of oil and gas production transactions. The Task Force has concluded that these non-uniform revisions go too far with respect to covering certain types of personal property collateral. The result is considerable non-uniformity and inconsistency within Article 9 and potential confusion as to the coverage of collateral such as vehicles and equipment. Nonetheless, as noted, the special connection between oil and gas production and real property law suggests a need to continue the Article 9 accommodation to real property concepts to some extent, while clarifying the rules and resolving the scope issues within Article 9.

E. Categories of Extracted Minerals — Scope of the Perfection Rules

The Task Force believes that minerals after extraction should continue to be treated as ordinary goods, subject to central filing in the UCC records, and that Article 9 should continue to draw a distinction as to security interests that attach to minerals being extracted (due to their relation to the realty). The next question is where and how to draw the line between these two categories for purposes of perfection. For example, the Oklahoma version of Section 9-402(5) covers "minerals to be severed from [the land]," potentially creating confusion as to whether minerals are covered before, upon, or after extraction. As noted, the uniform text also contains

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estate described.
U.C.C. § 9-403(7).
an anomaly that may create confusion: Sections 9-401(1), 9-402(1), 9-402(5),
and 9-403(7) apply to "minerals or the like (including oil and gas) or
accounts subject to subsection (5) of Section 9-103." 31 Section 9-103(5)
applies only to a security interest that attaches as the minerals are extracted,
and to any resulting accounts, in the context of an interstate choice of law
rule. As a consequence, there has been disagreement concerning the scope
of this rule, and it is not as clear as it might be whether the special oil and
gas perfection rules of Article 9 Part 4 apply to intrastate security interests
in oil and gas that attach upon extraction.

The Task Force has concluded that the special, real estate oriented
perfection rules for "minerals and the like (including oil and gas)" in
Article 9 Part 4 should be limited to security interests that attach to oil and
gas as they are extracted from the ground, leaving security interests that
attach to minerals after extraction subject to the ordinary perfection rules for
goods. This distinction is appropriate, as it may be practically impossible
to determine the source of oil and gas that has been extracted and commingled.
The distinction should be specifically recognized at Section 9-401(1).32

This view is consistent with the case law, as illustrated by In re
Fullop,33 where the bank secured its oil and gas production loan by taking
assignments of the debtor's leasehold and working interests, and recording
them under real property law. When the debtor filed bankruptcy, the debtor
(and then the trustee) argued that these real estate recordings represented a
security interest that was unperfected under Article 9 as to minerals being
extracted.34 The trustee contended that a security interest in minerals being
extracted can only be perfected by a central UCC filing, on grounds that
current Section 9-103(5)35 (incorporated by reference at Sections 9-401, 9-
402, and 9-403 as the trigger for application of the special filing rules for
minerals) applies only to interstate transactions and therefore does not
extend the special filing rules for minerals in Article 9 Part 4, to minerals
being extracted in intrastate transactions.36 The district court in Fullop
agreed that extracted minerals are subject to the Article 9 perfection
requirements, but concluded that the Section 9-103(5) provision covering
minerals upon extraction is not limited to interstate transactions, so that the

32. See supra note 26.
33. 6 F.3d 422 (7th Cir. 1993). See also Kames v. Salem Nat'l Bank (In re Fullop), 133 B.R.
627 (S.D. Ill. 1991), affd 6 F.3d 422 (7th Cir. 1993); (discussing the district court's analysis of the
issues); HARRELL ET AL., supra note 13, at 283 (noting the interface between real and personal
property law as to minerals being extracted is traditionally resolved by deference to the real estate recording act).
34. See 6 F.3d at 426-27; 133 B.R. at 630.
35. See supra note 10.
36. 133 B.R. at 634-35.
special Article 9 Part 4 perfection rules for minerals cover oil and gas upon extraction in intrastate transactions.\textsuperscript{37}

Currently there is a lack of clarity in terms of the meaning and applicability of Section 9-103(5) in the context of intrastate transactions generally, and with respect to the Article 9 Part 4 perfection issues in particular. As a result of the rather oblique interplay between Section 9-103(5) and Sections 9-401, 9-402, and 9-403, the appropriate perfection rule for minerals being extracted in intrastate cases is not as clear as it could be. While \textit{In re Fullop} correctly resolved this issue, and indeed the incorporation of Section 9-103(5) into Sections 9-401, 9-402, and 9-403 may be more clear than that court recognized, the fact remains that the \textit{Fullop} analysis was more difficult than necessary. The status and coverage of the perfection rules for extracted oil and gas therefore should be clarified as part of any Article 9 revision. The Task Force recommends that a self-contained filing rule be provided in Section 9-401 for security interests that attach to oil and gas upon extraction, and that a security interest attaching after extraction be governed by the rules applicable to ordinary goods.

\textbf{F. Perfection as to Minerals Upon Extraction}

The next problem is to determine what kind of filing or perfection rule is appropriate for security interests that attach to minerals upon extraction. Under current law, as a result of the interplay between UCC Sections 9-103(5) and Article 9 Part 4, a security interest which attaches to minerals upon extraction may be perfected by a UCC filing in the real estate records, while most other mineral production and related personal property remains subject to the normal Article 9 perfection rules. This creates a "split personality" within Article 9,\textsuperscript{38} and raises a question: To what extent is such a split necessary or appropriate in view of the transition of minerals from real to personal property?

The treatment of minerals upon and after extraction represents a major decision-point in any consideration of the Article 9 treatment of minerals and related collateral. Once the decision is made to require perfection as to

\textsuperscript{37} \textit{Id}. at 639. The Task Force agrees with this view. Under the current text of the UCC this requires a local filing in the real estate records for minerals being produced by the debtor. \textit{Id}; see also 6 F.3d at 427 (discussing the court of appeals' analysis). In \textit{In re Fullop}, the bank's recorded leasehold and working interest assignments were found to be sufficient for perfection under Article 9. As noted above and infra in part IV.F, the Task Force favors reaffirmation of this rule. \textit{But see} 6 F.3d at 428-31 (concluding that under real property law the rents and profits clause in a real estate mortgage constitutes an alternative route to perfecting a security interest in minerals being extracted). The Task Force does not endorse that conclusion, believing that Article 9 should be the sole source of law governing a security interest in oil and gas upon and after extraction.

\textsuperscript{38} ``Thus, the UCC codified the pre-extraction and post-extraction dichotomy established by the state courts." 133 B.R. at 633. \textit{But see supra} note 37.
mineral production by a filing in the real estate records, it may then follow that other, related collateral (e.g., leases, contracts, accounts, and proceeds) also should be subject to the same perfection rules so that this aspect of a given transaction will not require multiple filings.\textsuperscript{39} Furthermore, the local, real estate-oriented nature of mineral production suggests a need for some sort of local filing. Where, then, to draw the line between deference to real property law and internal consistency within Article 9?

The Task Force recommends that perfection as to minerals being produced (i.e., perfection of a security interest that attaches to minerals upon extraction) should be achieved by recording a real estate mortgage or filing a financing statement (containing a legal description) in the real estate records of the county where the well is located. The Task Force favors requiring that the description of the collateral in such a financing statement include a description of the land, as is the case with other real estate-related collateral such as growing fixtures and crops.\textsuperscript{40} A security interest that attaches to minerals after extraction would not be subject to this requirement, and would be perfected by a filing in the UCC central records, as with any other business goods. Security interests perfected locally upon extraction would continue to be perfected after extraction pursuant to Section 9-401(3).\textsuperscript{41}

\begin{footnotes}
\item [39] "Together, then, 9-103(5) and 9-401(1) telescope perfection questions to the state and county of the wellhead or minehead. This relieves the creditor from the central and perhaps other local filings typically required for ordinary inventory and accounts. . . ." 133 B.R. at 636 (quoting JAMES J. WHITE \& ROBERT S. SUMMERS, \textit{UNIFORM COMMERCIAL CODE} §§ 24-25 (3d ed. 1988)); see also HARRELL ET AL., \textit{supra} note 13, at 283-84 (discussing the maximum possible protection and solutions to multiple filing).

\item [40] \textit{See} U.C.C. §§ 9-203(1)(a), 9-313(1)(b), 9-402(1), 9-402(5), 9-103(5). However, as noted \textit{supra} at notes 15 and 37, the Task Force does not endorse the conclusion by the Seventh Circuit in \textit{In re Fullop} that a real estate mortgage rents and profits clause should be an alternative means to create and perfect a security interest in extracted minerals outside of Article 9.

In \textit{In re Fullop} the court of appeals suggested that a security interest perfected by real estate mortgage would not be subject to the Article 9 requirement for filing a continuation statement every five years because the perfection would be governed by real property law and not Article 9. \textit{See} 6 F.3d at 427-29; U.C.C. §§ 9-403(2), (3). The Task Force agrees that a continuation statement should not be necessary in this circumstance, and recommends adoption of a revision similar to OKLA. STAT. tit. 12A, § 9-403(7), (West Supp. 1994) to specify this result, but disagrees with the Seventh Circuit’s conclusion that this issue is or should be governed by real property law.

\item [41] U.C.C § 9-401(3) provides:

(3) A filing which is made in the proper place in this state continues effective even though the debtor’s residence or place of business or the location of the collateral or its use, whichever controlled the original filing, is thereafter changed.

\textit{Alternative Subsection (3)}

(3) A filing which is made in the proper county continues effective for four months after a change to another county of the debtor’s residence or place of business or the location of the collateral, whichever controlled the original filing. It becomes ineffective thereafter unless a copy of the financing statement signed by the secured party is filed in the new county within said period. The security interest may also be perfected in the new county after the expiration of the four-month period; in such case perfection dates from the time of perfection in the new county. A change in
\end{footnotes}
unless cut off by a sale at the wellhead to a buyer in the ordinary course of business under Sections 9-307(1)\textsuperscript{42} and 1-201(9).\textsuperscript{43} Priority disputes between these two classes of security interests would be governed by the rules applicable to commingled goods, found in Section 9-315.\textsuperscript{44}

G. Summary of Recommendations — Extracted Minerals

The recommended approach would preserve the current three categories of perfection rules for minerals: (1) minerals in the ground (subject to real property law); (2) minerals upon extraction (subject to Article 9 but perfected by a local filing in the real estate records); and (3) minerals after extraction (subject to central UCC filing but also potentially subject to prior claims under category two above and Section 9-315). Essentially this would preserve the current thrust of Article 9, with clarifications in the statutory language as to the scope of the real estate-oriented filing rules at Section 9-401. The dependence of Section 9-401 on Section 9-103(5) would be eliminated, and a self-contained scope provision would be included in Section 9-401 (requiring a real estate filing for minerals being extracted). Prior claims to extracted minerals under real property law would be curtailed under Section

\footnotesize{the use of the collateral does not impair the effectiveness of the original filing.]

U.C.C. § 9-401(3).

\textsuperscript{42} See supra note 7.

\textsuperscript{43} UCC § 1-201(9) provides:

(9) "Buyer in ordinary course of business" means a person who in good faith and without knowledge that the sale to him 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 but does not include a pawnbroker. All persons who sell minerals or the like (including oil and gas) at wellhead or minehead shall be deemed to be persons in the business of selling goods of that kind. "Buying" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

U.C.C. § 1-201(9).

\textsuperscript{44} UCC § 9-315 provides:

(1) If a security interest in goods was perfected and subsequently the goods or a part thereof have become part of a product or mass, the security interest continues in the product or mass if

(a) the goods are so manufactured, processed, assembled or commingled that their identity is lost in the product or mass; or

(b) a financing statement covering the original goods also covers the product into which the goods have been manufactured, processed or assembled.

In a case to which paragraph (b) applies, no separate security interest in that part of the original goods which has been manufactured, processed or assembled into the product may be claimed under Section 9-314.

(2) When under subsection (1) more than one security interest attached to the product or mass, they rank equally according to the ratio that the cost of the goods to which each interest originally attached bears to the cost of the total product or mass.

U.C.C. § 9-315.
9-307(1), as noted supra at part IV.A. In addition, the distinction between unextracted minerals in the ground and extracted minerals being stored underground would be clarified, so that extracted minerals being stored underground would be classified as goods.

This proposal would treat all extracted minerals consistently as personal property under Article 9, with a distinction as to the place of filing (local real estate or central UCC records). This would essentially retain the current structure of Article 9. However, as noted, revisions would need to be considered to clarify the special filing rules in Article 9 Part 4 for minerals being extracted. This could be accomplished by amendment of the perfection rules at Sections 9-401(1), 9-402(1), 9-402(5), and 9-403(7) to delete the reference to Section 9-103(5) and to provide a self-contained local filing rule for security interests that attach to minerals being extracted. The revised language should make clear that security interests that attach to minerals after extraction are subject to the usual filing rules for other goods. The language at Section 9-103(5) would be limited to interstate choice of law issues.

H. An Alternative Approach

One other possibility is to treat all extracted minerals as ordinary goods, ignoring any connection to the county where the well site is located. The members of the Task Force considered but generally did not favor this alternative view. While this would result in greater simplicity and internal consistency within Article 9, it would also confront strong traditions to the contrary in mineral producing states. Therefore, the Task Force recommends continuing the distinction between (and different perfection rules for) security interests that attach to minerals being extracted as opposed to those which attach to minerals previously extracted. In both instances, however, the Task Force recommends that extracted minerals be treated as goods, subject exclusively to Article 9.

1. Competing Claims Under Real and Personal Property Law

As noted supra, the relationship between real and personal property is a complicating factor in mineral financing. The Task Force concluded that it is important to minimize the resultant uncertainties by clarifying the rights of competing parties under both real and personal property law, somewhat as similar rights in fixtures are resolved under Section 9-313.45

45. The Task Force does not necessarily recommend Section 9-313 as a model for this purpose, though there are similarities between that approach and this report. UCC § 9-313 provides:
(1) In this section and in the provisions of Part 4 of this Article referring to fixture filing, unless the context otherwise requires
   (a) goods are "fixtures" when they become so related to particular real estate that an interest in them arises under real estate law.
   (b) a "fixture filing" is the filing in the office where a mortgage on the real estate would be filed or recorded of a financing statement covering goods which are or are to become fixtures and conforming to the requirements of subsection (5) of Section 9-402.
   (c) a mortgage is a "construction mortgage" to the extent that it secures an obligation incurred for the construction of an improvement on land including the acquisition cost of the land, if the recorded writing so indicates.

(2) A security interest under this Article may be created in goods which are fixtures or may continue in goods which become fixtures, but no security interest exists under this Article in ordinary building materials incorporated into an improvement on land.

(3) This Article does not prevent creation of an encumbrance upon fixtures pursuant to real estate law.

(4) A perfected security interest in fixtures has priority over the conflicting interest of an encumbrancer or owner of the real estate where
   (a) the security interest is a purchase money security interest, the interest of the encumbrancer or owner arises before the goods become fixtures, the security interest is perfected by a fixture filing before the goods become fixtures or within ten days thereafter, and the debtor has an interest of record in the real estate or is in possession of the real estate; or
   (b) the security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record, the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner, and the debtor has an interest of record in the real estate or is in possession of the real estate; or
   (c) the fixtures are readily removable factory or office machines or readily removable replacements of domestic appliances which are consumer goods, and before the goods become fixtures the security interest is perfected by any method permitted by this Article; or
   (d) the conflicting interest is a lien on the real estate obtained by legal or equitable proceedings after the security interest was perfected by any method permitted by this Article.

(5) A security interest in fixtures, whether or not perfected, has priority over the conflicting interest of an encumbrancer or owner of the real estate where
   (a) the encumbrancer or owner has consented in writing to the security interest or has disclaimed an interest in the goods as fixtures; or
   (b) the debtor has a right to remove the goods as against the encumbrancer or owner. If the debtor's right terminates, the priority of the security interest continues for a reasonable time.

(6) Notwithstanding paragraph (a) of subsection (4) but otherwise subject to subsections (4) and (5), a security interest in fixtures is subordinate to a construction mortgage recorded before the goods become fixtures if the goods become fixtures before the completion of the construction. To the extent that it is given to refinance a construction mortgage, a mortgage has this priority to the same extent as the construction mortgage.

(7) In cases not within the preceding subsections, a security interest in fixtures is subordinate to the conflicting interest of an encumbrancer or owner of the related real estate who is not the debtor.

(8) When the secured party has priority over all owners and encumbrancers of the real estate, he may, on default, subject to the provisions of Part 5, remove his collateral from the real estate but he must reimburse any encumbrancer or owner of the real estate who is not the debtor and who has not otherwise agreed for the cost of repair of any physical injury, but not
As already noted, the Task Force recommends that real estate lien interests (including any claim asserted under a real estate mortgage or deed of trust) in minerals in the ground (created by the seller of oil and gas production) be included in the class of interests cut off by a sale of the minerals at the wellhead to a buyer in the ordinary course of business.\textsuperscript{46} This would resolve priority disputes between such buyers and any type of competing realty interest.

However, under current law this might not resolve disputes between real property mortgagees (or royalty owners asserting a statutory lien) and secured creditors of the operator or working interest owner, as to minerals extracted but not yet sold. Such minerals might be in storage on or off the property. (Similar priority disputes may arise with regard to mineral production equipment located on the property, as discussed infra.)

An example would be a priority conflict between a prior real estate mortgagee and an Article 9 security interest granted by a working interest owner, as to extracted minerals in storage on the property. To resolve this conflict, the Task Force recommends purchasers from the working interest owner (including Article 9 secured parties) be included within the definition of “buyer in the ordinary course of business” as to the working interest owner’s share of the oil and gas production (as determined by the oil and gas lease and division order), for purposes of Section 9-307(1).\textsuperscript{47} An Article 9 security interest in a working interest owner’s share of production would also be treated as a purchase money security interest. This would permit the working interest owner to grant a security interest in mineral production to finance that production, with the secured party assured of first priority as to the working interest owner’s share of any minerals produced and its proceeds. A mortgagee, and any statutory lien claimant (such as a royalty owner) would be limited to a priority claim against the proportionate share reserved by the mortgagor or owner.\textsuperscript{48} Proportionate claims against commingled minerals

for any diminution in value of the real estate caused by the absence of the goods removed or by any necessity of replacing them. A person entitled to reimbursement may refuse permission to remove until the secured party gives adequate security for the performance of this obligation.

As amended in 1972.

U.C.C. § 9-313.

\textsuperscript{46} See supra part IV.A.

\textsuperscript{47} See supra note 7.

\textsuperscript{48} This appears to be consistent with Texas nonuniform UCC § 9.319, since that section extends only to the operator’s obligation to the mineral interest owner with regard to the mineral interest owner’s share of the minerals sold. See TEX. BUS. & COM. CODE ANN. § 9.319(a) (Tex. UCC) (Vernon 1991): “This section provides a security interest in favor of interest owners . . . to secure [the operator’s obligation] . . . to pay the purchase price.” See also TEX. BUS. & COM. CODE ANN. § 9.319(q)(3) (Tex. UCC) (Vernon 1991) (explaining when an interest owner or operator will be considered a “first purchaser” for perfection purposes under Section 9.319). However, this point is not made clear in the Texas statute. See infra note 52. Cf. \textit{In re Fullop}, 6 F.3d 422, 428-31 (7th Cir. 1993) (concluding that a real estate mortgage offers alternative means to perfect a security interest in mineral production, under real property law).
and their proceeds would be governed by Section 9-315.49

This solution would be fair to such claimants because generally they have not relied on any claim to a working interest owner’s share of production (if there is such reliance the claim should be perfected under Article 9). Furthermore, the real property mortgagee would still be entitled to appropriate priority under real property law as to minerals remaining in the ground, and therefore should be able to protect itself as to future production by a foreclosure of the mortgage (unless it has agreed to subordination of the mortgage, in which case there can be no claim to priority).

J. Summary of Recommendations—Real Versus Personal Property Aspects of Secured Transactions as to Extracted Minerals

These recommendations are in part an effort to address conflicts between Article 9 security interests and prior claims to extracted minerals under state statutory lien laws. Such real property claims also may arise under the standard mortgage rents and profits clause in a real estate mortgage. The Task Force believes that an effort should be made to resolve these problems within Article 9, somewhat as Section 9-31350 resolves similar problems with regard to fixtures. As noted supra, the Task Force recommends treating extracted minerals as goods, and extending the protection of the buyer in the ordinary course of business rule at Section 9-307(1)51 to cover claims of real property interests to extracted minerals. Section 9-307(1) would then cover (and cut off) the claims of real property liens on minerals sold at the mine (or wellhead) to a buyer in the ordinary course of business.52 This would include the “sale” of production attributable to a working interest owner pursuant to an oil and gas lease and division order. As a result, lenders to working interest owners would be able to finance oil and gas production in much the same way they finance any other inventory of goods, subject to the special filing rules at Section 9-401.

49. See supra note 44.
50. See supra note 45.
51. See supra note 7.
52. As noted supra, this is generally consistent with the Texas nonuniform amendment at § 9.319, which creates a statutory lien (labeled an automatic purchase money security interest) in favor of mineral interest owners, as against the “first purchaser” of oil and gas production. See Tex. Bus. & Com. Code Ann. § 9.319(a), (b) (Tex. UCC) (Vernon 1991). This lien is specifically subject to the claim of a buyer in the ordinary course of business. See id. § 9.319(c). Since “first purchaser” is defined to include the well operator (§ 9.319(q)(3)), the result is that the mineral interest owner would have a purchase money security interest in his or her share of production, co-equal to a security interest created by the operator. Both interests would be purchase money security interests, though each would attach to a different share of the production. Of course a sale of oil and gas by the operator would cut off both security interests as against the purchaser. The Task Force merely recommends that the Article 9 revisions clarify these points. See also discussion infra at part VII (discussing oil and gas owner’s lien acts in other states).
In essence these revisions would require the cautious lender financing production by a well operator or working interest owner to file in the central UCC records (as to previously extracted minerals and accounts), and to file additionally in the local real estate records (as to minerals being or to be extracted). This relationship between real and personal property law represents a major decision-point in any consideration of potential Article 9 revisions, and the Task Force recommends a solution based on consistent treatment of extracted minerals as personal property under Article 9, including termination of whatever residual claims may exist under local real property law upon production of minerals at the wellhead and their sale to a buyer in the ordinary course of business (including the well operator). However, the Task Force also recommends retaining the current distinction between security interests that attach upon extraction and those that attach after extraction, with local filing for the former and central filing for the latter, all within Article 9. The problems created by the state mineral owners’ lien statutes are also discussed infra at part VII.

V. LEASES AND OTHER CONTRACTUAL RIGHTS

The Task Force concluded that oil and gas leases, prospecting permits, pooling and unitization agreements, and farmout agreements should be treated as real property and excluded from Article 9 under Section 9-104(j). This would resolve current uncertainties under state law, since there is little in the way of a common law basis for making this determination and in many cases courts have done an inadequate job of analyzing the relevant issues. (Without undertaking a comprehensive survey, it appears that most courts simply treat oil and gas leases as real property, on somewhat of an intuitive basis.)

53. In In re Fullop, 6 F.3d 422, 427-31 (7th Cir. 1993), the lender was perfected as to minerals being extracted, because the lender recorded its assignment in the real estate records. The Task Force recommendation would confirm this result under Article 9, but not the court’s conclusion that a security interest in extracted minerals can be created by the mortgage outside of Article 9.

54. “Farmout agreement” is now defined in the Bankruptcy Code as a written agreement in which:

(A) the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and

(B) such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property.

11 U.S.C. § 101(21A) (Supp. IV 1992). Article 9 could be revised to include a similar definition.

55. See supra note 11.

56. See, e.g., Kames f. Salem Nat’l Bank (In re Fullop), 133 B.R. 627, 631-32 (S.D. Ill 1991), aff’d 6 F.3d 422 (7th Cir. 1993) quoting Jilek v. Chicago, Wilmington & Franklin Coal Co., 47 N.E.2d 96, 96-100 (Ill. 1943) (“Oil and gas leases granting the right to search for and take oil and gas are freehold estates in the land. . . . The right to explore for these substances and to reduce them to
While this is not necessarily an inevitable conclusion, it appears to be the most practical solution. The alternative, in terms of Article 9, is that such interests could qualify as accounts or general intangibles under Section 9-106,57 if they are characterized as personal property under state law. However, this would constitute a significant change in the law of most states.

Other contractual interests are more closely seen as personal property—such as oil lease bonus payments,58 delay rental payments, production payments,59 operating agreements, sales contracts, production sales contracts, processing and transportation contracts. As typically drafted, these interests do not carry any pretense of representing a claim to minerals in the ground, yet are sometimes treated as real property under state law. In other states, such interests may currently qualify as Article 9 general intangibles.60

While the characterization of these interests is debatable, the Task Force recommends characterization of interests according to their relationship to the land. Generally, those interests relating to minerals in the ground or relating to the production of minerals would be treated as real estate and excluded from Article 9. Examples already noted include leases, royalty interests, pooling and unitization agreements, prospecting permits, and farmout agreements. On the other hand, those interests relating to post-
production or non-production activities would be treated as Article 9 "general intangibles." Examples include delay rental payments, lease bonus payments, processing sales, transportation, and storage contracts. Thus, a substantive characterization rule is needed because the courts and other parties are not consistent in their use of these labels. 61

There remains an "in-between" category of contractual interests, related to both real and personal property aspects of oil and gas law in ways that may vary from state-to-state and even from case-to-case within a state. Examples include exploration agreements, production payment contracts, and operating agreements. The variations involved defy a consistent characterization, and for such interests the Task Force recommends a functional approach that would direct the courts to characterize each interest in question according to its relationship to the land. The courts seem prone to treat oil and gas related contractual interests relating directly to the lease or to a proportionate share of the well production as real property, so this system of characterization would be consistent with the law of most oil and gas producing states. 62 The Task Force is thus inclined to recognize and specify the dividing line between real and personal property law as to certain commonly encountered types of interests, both using common labels and a general descriptive rule, leaving it to the courts to specify the dividing line in either case by means of a stated functional test.

In Oklahoma and Texas, nonuniform amendments to Sections 9-401 and 9-402 call for Article 9 perfection as to oil and gas leasehold estates by recordation of a real estate mortgage. As noted supra, this reflects an apparent effort to provide single record coverage for a variety of oil and gas related collateral. The Task Force recommends going beyond the Texas-Oklahoma approach by classifying oil and gas leases within the definition of real property at Section 9-104(1), 63 thereby excluding them, and like interests, from Article 9 altogether. This would also go beyond the deference to real property recording acts in the uniform text at Sections 9-401(1) (in all three alternatives), 9-402(1), 9-402(5), and 9-403(7), for timber to be cut, minerals, and fixtures. 64 This approach should reduce the problems caused by nonuniform amendments with regard to these issues, and eliminate the resulting inconsistencies in the text of Article 9. 65 The Task Force

61. See, e.g., Octagon Gas Sys., Inc. v. Rimmer, 995 F.2d 948, 951-60 (10th Cir.) (where a gas distribution contract was repeatedly referred to as an "overriding royalty interest"). cert. denied, 114 S. Ct. 554 (1993).

62. In re Fullop treated the debtor's working interests as real property, citing local law, after noting that oil and gas interests may be characterized either as real or personal property. See also HARRELL ET AL., supra note 13, at 278-79 (characterizing leasehold interests, production payments contracts, and working interests as forms of contractual interests potentially subject to real property law).

63. See supra note 11.

64. See also U.C.C. §§ 9-103(5), 9-313(1) (referring to minerals and fixtures, respectively).

65. As just one example, in Oklahoma a security interest in an oil and gas lease is perfected by
recommendation is to specifically draw a line excluding all minerals in the ground and related contractual interests from Article 9, including contractual interests directly relating to mineral production, while including in Article 9 other contractual interests, extracted minerals, and any related tangible personal property.

VI. EQUIPMENT AND VEHICLES

The nonuniform amendment to Oklahoma Section 9-402(5)\textsuperscript{66} portrays some of the consequences of deference to real property law for oil and gas transactions. This Section provides that an Article 9 security interest in "equipment used in mining, storing, treating and marketing such minerals" may be perfected by recording a real estate mortgage.\textsuperscript{67}

The exact reach of this provision is unclear. For example, does it apply to vehicles being used to transport minerals, thereby preempting the certificate of title "lien entry" system?\textsuperscript{68} Is it limited to equipment being "used" for production, etc., so that drilling rigs being "stacked" between jobs, or any other equipment associated with a nonproducing well, would be excluded from the special perfection rule and hence be subject to the normal central filing requirements for business equipment? Does it apply to equipment used solely for exploration, such as seismic equipment? Is the four month "grace period" for refiling\textsuperscript{69} applicable to enable a lender to accommodate changes that trigger application of or exclusion from the special rule?

Even if these questions could be answered with certainty, the Oklahoma provision's "use of collateral" test creates significant nonuniformity within Article 9. Equipment that is subject to central filing in the UCC records under Section 9-401 may become subject to local filing in the real estate records by reason of its association with oil and gas production. There is an equivalent provision in the uniform text, for equipment being used in farming operations,\textsuperscript{70} and both provisions provide different filing rules for

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\textsuperscript{66} See Okla. Stat. tit. 12A, § 9-402(5) (Supp. 1994). There is, however, no mention of production payments contracts in this nonuniform provision describing a special rule for leases. This may reflect a local distinction between leases (specified in the nonuniform filing provision in Oklahoma Section 9-402(5)) and production payments contracts (not mentioned in Oklahoma's Section 9-402(5)), or it simply may reflect a legislative oversight. In either case, it does not provide consistency or adequate guidance as to the scope of Article 9.

\textsuperscript{67} Id. See generally, Harrell et al., supra note 13, at 283, 287-93.


\textsuperscript{69} The four month "grace period" for refiling is found in alternative subsection (3) of the U.C.C. § 9-401.

\textsuperscript{70} Id. § 9-401(1) (second and third alternatives).
identical equipment, depending on how the equipment is used. Since few people can predict with certainty how equipment will be used in the future, or even how it has been used in the past, effective perfection and title searches become somewhat difficult. The resulting convenience of filing locally for oil and gas or agricultural equipment must, therefore, be balanced against the considerable uncertainty that results.

Much oil-and gas-related equipment is single-use property used only in conjunction with an oil or gas well, and in some ways is akin to a fixture. An argument can be made in favor of allowing perfection for such equipment by the same filing used to cover the minerals being extracted, by using a system of local filing in the real estate records (like a fixture). As noted, however, any provision for a local filing for inherently mobile equipment, based on its current use, raises significant risks in the event there is a change in the use or location of the collateral.

As just one example, in Oklahoma a mobile home may be subject to five possible characterizations and perfection systems, depending on its use and other factors: (1) The certificate of title lien entry system (as a vehicle); (2) local filing in the UCC records (as consumer goods); (3) a UCC filing in the real estate records (as a fixture); (4) a central filing in the UCC records (as inventory); and (5) by real estate mortgage (as oil and gas equipment). The members of the Task Force support treatment of all oil and gas (and other mineral) related vehicles and equipment as personal property, subject to central UCC filing, except as supplanted by a motor vehicle lien entry system.

The Task Force considered and rejected arguments favoring inclusion of such vehicles and equipment (except vehicles subject to lien entry perfection) in the proposed local filing rule for oil and gas upon extraction, under Section 9-401(1). The Task Force also rejected characterization of such equipment as a fixture, on grounds that such equipment is not intended as a permanent fixture and is either removed or abandoned when a well is shut in. Thus, the Task Force recommends that such equipment and vehicles be treated as ordinary personal property subject only to perfection in the UCC records or under the state lien entry system for vehicles.

These same considerations are confronted in Article 9 with regard to farm equipment, and there is something to be said for treating these categories the same. In fact, in some cases the argument for a local filing as to mineral equipment is probably stronger because much of the equipment used in oil and gas production is single-purpose equipment, and hence, a third party is on notice that it may be subject to special rules. Nonetheless,

71. The resulting uncertainty apparently prompted the Oklahoma legislature to enact legislation providing that a security interest properly perfected against a mobile home as personal property would retain priority if the collateral subsequently becomes subject to a real estate mortgage. See Okla. Stat. tit. 47, § 1110.E. (1988).
the Task Force members concluded that such equipment should be subject only to perfection by a filing in the UCC records or under the motor vehicle lien entry system.

VII. OIL AND GAS OWNERS’ LIEN ACTS

Kansas, Oklahoma, and Texas (among others) have enacted statutory lien acts purporting to provide mineral interest owners with a form of statutory “security interest” or lien in oil and gas production and its proceeds.72 While designed to address a legitimate concern (the risk that a working interest owner may produce and sell minerals without remitting the appropriate proceeds to the mineral interest owner), these statutes potentially conflict with (or at least complicate) the Article 9 priority system.73

The Task Force recommends limiting the scope of the mineral interest lien to that portion of mineral production attributable to the mineral interest owner’s (lessor’s) share of production, whether in value or in kind, and identifiable proceeds, so as to avoid conflict with any security interest in that portion of production attributable to the working interest owners’ proportionate share of production. This would be accomplished in part by characterizing the buyers and secured creditors of working interest owners (e.g., lessees) as buyers (normally in the ordinary course of business) of the production attributable to such parties’ interest. Therefore, any resulting security interest in that production is treated as a purchase money security interest entitled to first priority.74 This approach would essentially adopt the methodology of Kansas Section 84-9-31975 and Texas Section 9.31976 (at


73. See Harrell, supra note 16. Superficially these issues bear some resemblance to those addressed in the agricultural context by statutory trust fund and other lien statutes designed to protect farmers from insolvent purchasers of farm products. However, the differences in context (between agricultural and mineral production) limit the value of analogies that may be drawn between these types of transactions.

74. As noted in the text, this approach is generally consistent with much of the statutory priority rules of Texas UCC § 9.319(g) and Kansas UCC § 84-9-319(6) and (7), except that the Task Force proposal would specifically limit the mineral interest owner’s claim to his or her proportionate share of production and its proceeds, would recognize the equal priority of claims of other secured parties to the operator’s proportionate share, and would not refer to real property law to determine priorities among security interests. Cf. Kan. Stat. Ann. § 84-9-319(7)(a) (1991 Supp.) (noting priority among perfected security interests is determined by real estate law); Tex. Bus. & Comm. Code Ann. § 9.319(g)(1) (Tex. UCC) (Vernon 1994) (spelling out certain priorities between competing security interests determined under real property law). The Task Force also believes that such liens should be viewed only as statutory liens, and not purchase money security interests as is the case with the Texas provision. Thus, the lien would be subordinate to genuine purchase money security interests. These goals could be met by a revised (and optional) version of Texas UCC § 9.319.

least where the working interest owner disburses the proceeds), while specifically limiting the reach of these statutes to the interest owner's share of production. This would represent an evolutionary change in the Article 9 treatment of oil and gas transactions.

Concerns about the possible impact of the Oklahoma Lien Act were alleviated on November 1, 1991, when the United States Court of Appeals for the Tenth Circuit addressed the relationship between Article 9 and the Oklahoma Lien Act.77 In Arkla Exploration Co. v. Norwest Bank,78 a group of other interest owners in Oklahoma gas wells claimed priority over the perfected security interest of Norwest Bank on grounds that their statutory liens related back to the date of production and therefore were prior in time to the Norwest security interest.79

The Tenth Circuit concluded, however, that the issue is resolved by the plain meaning of the statutory language, which provides that the Oklahoma Lien Act shall not "impair or affect the rights and remedies of any person under the provisions of the Oklahoma UCC."80 This case, and the straightforward statutory language on which it is based, should eliminate for now any threat to the priority of Article 9 security interests from the Oklahoma Lien Act. Thus, the potential threat from mineral owners' lien acts is primarily limited to the Kansas and Texas approach. Nonetheless, the 1991 adoption by Kansas of a statutory lien provision patterned after Texas UCC Section 9.31981 suggests that these issues will need to be addressed in any revision of Article 9.

VIII. SUMMARY AND CONCLUSIONS

The conclusions and recommendations of the Task Force can be summarized as follows:

1. The relationship between real and personal property law and related conflicts in the context of mineral finance should be addressed and resolved in Article 9 by specifying the scope of the laws applicable to each type of mineral-related collateral.

2. Minerals in the ground and related contractual interests (including oil and gas leases) should be treated as real property and excluded from Article 9. Contractual interests not related to

77. Arkla Exploration Co. v. Norwest Bank, 948 F.2d 656 (10th Cir. 1991). But see supra note 74 (discussing the Kansas and Texas statutes).
78. 948 F.2d at 656.
79. Id. at 659. Section 548.4.C of the Oklahoma Lien Act provides for such relation back. However, as discussed infra, the 10th Circuit determined that it was not necessary to reach that issue.
80. 948 F.2d at 659 (quoting Okla. Stat. tit. 52 § 548.6.C. (1992)). See also Harrell et al., supra note 13, at 294-95.
minerals in the ground or their production should be treated as accounts or general intangibles under Article 9.

3. Extracted minerals should be treated as personal property governed exclusively by Article 9, and claims arising under real property law should be subject to termination under UCC Section 9-307(1). For this purpose, "buyer in the ordinary course of business" should be defined to include the mineral operator and other working interest owners (as regards those parties' shares of production), in order to protect the secured creditors of such parties from claims of real property mortgagees as well as mineral interest owners and their creditors.

4. UCC Section 9-401 should require that any security interest which attaches to minerals upon extraction be perfected by recording a mortgage or filing a financing statement (with a description of the real estate) in the county where the well is located. Security interests which attach after extraction would be perfected centrally as with any other goods.

5. Security interests in vehicles and equipment should be subject to the ordinary Article 9 rules or other state laws for such equipment and should not be affected by the use of such collateral in oil and gas or other mining operations. Real estate interests should not extend to any mining or oil and gas production equipment, and such equipment should not be classified as a fixture.

6. The scope of state mineral interest owner liens should be limited to the production attributable to the mineral interest, whether taken in kind or in value and attributable proceeds.82

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82. The following are members of the UCC Committee Task Force or have otherwise participated in this project: Kenneth M. Anderson, Houston, Texas; Owen L. Anderson, Norman, Oklahoma; George W. Bermant, Denver, Colorado; Amelia Boss, Philadelphia, Pennsylvania; Juan Saavedra-Castro, San Juan, Puerto Rico; Terry L. Cross, Dallas, Texas; Allen D. Cummings, Houston, Texas; Tony M. Davis, Dallas, Texas; Samuel A. Denny, Fort Worth, Texas; Ned Dismukes, Tulsa, Oklahoma; David G. Dunlap, Houston, Texas; Judson Fambrough, College Station, Texas; Frank T. Garcia, Houston, Texas; Thomas F. Getten, New Orleans, Louisiana; Robert H. Gilliland, Oklahoma City, Oklahoma; Stephen J. Goetzinger, Oklahoma City, Oklahoma; Alvin C. Harrell, Oklahoma City, Oklahoma; Thomas A. Harrell, Baton Rouge, Louisiana; Karen L. Howick, Oklahoma City, Oklahoma; Bill J. Howard, Midland, Texas; Edward J. Lieberman, St. Louis, Missouri; Robert Luttrell, Oklahoma City, Oklahoma; Eileen Maguire, New York, New York; Marilyn C. Maloney, New Orleans, Louisiana; Fred H. Miller, Norman, Oklahoma; Dwight Moorehead, Littleton, Colorado; Douglas H. Morgan, Oklahoma City, Oklahoma; Patrick S. Ottinger, Lafayette, Louisiana; John P. Roberts, Oklahoma City, Oklahoma; Gretchen L. Roddy, Chickasha, Oklahoma; Robert N. Rule, Jr., Dallas, Texas; James R. Ryan, Tulsa, Oklahoma; Leopold Z. Sher, New Orleans, Louisiana; Alan R. Sloate, Fairfax, Virginia; Eve Sun, South Brisbane, Australia; Lyndon Taylor, Houston, Texas; Michael B. Tolson, Tulsa, Oklahoma; David Whittaker, Tulsa, Oklahoma; Peter Winship, Dallas, Texas.