

Oklahoma Law Review

Volume 36 | Number 4

1-1-1983

Oil and Gas: Security Interests Under the A.A.P.L. Form 610-1977 Model Form Operating Agreement

Randall Wood

Follow this and additional works at: <https://digitalcommons.law.ou.edu/olr>



Part of the [Law Commons](#)

Recommended Citation

Randall Wood, *Oil and Gas: Security Interests Under the A.A.P.L. Form 610-1977 Model Form Operating Agreement*, 36 OKLA. L. REV. 916 (1983),
<https://digitalcommons.law.ou.edu/olr/vol36/iss4/10>

This Note is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact darinfox@ou.edu.

(A) The third person is contributing to the support of the alimony recipient and the alimony recipient therefore does not need the amount of support previously awarded, and the court therefore should suspend all or part of the alimony obligation of the former spouse; or

(B) That the third person is receiving support from the alimony recipient and the alimony recipient therefore does not need the amount of alimony previously awarded and the court therefore should suspend all or part of the alimony obligation of the former spouse.

This subsection shall in no way be construed to create any common-law marriage obligation as to third parties.⁷⁰

This statute incorporates the *Garlinger* test, but expands the presumption beyond housemates in a private conjugal relationship. The Oklahoma court has already indicated its receptiveness to such an expansion. Because the statute provides for suspension rather than termination, the payor is afforded the relief he deserves without penalizing the recipient. Most important, the classification is directly related to the purpose of the statute.

The Oklahoma legislature should adopt either the Tennessee or a like statute and repeal the present live-in lover statute immediately. Although the court unequivocally avowed in *Smith* that the object of the statute is to allow modification of support alimony and not to punish a cohabiting recipient, the result of *Roberts* was to punish the still financially dependent appellant for such conduct. Unfortunately, the court, acting in compliance with this bad statutory provision, can now punish behavior that is lawful and wholly unrelated to the purpose of alimony for support. Because the court already has shown its propensity to use this power unfairly, the legislature should take immediate action to stop this injustice.

Lee Ann Jones

Oil and Gas: Security Interests Under the A.A.P.L. Form 610-1977 Model Form Operating Agreement

In the past twenty-five years, the A.A.P.L. Form 610-1977 Model Form Operating Agreement has emerged as the primary industry contract for the joint development of oil and gas properties. The Model Form Operating Agreement allows cotenants in the same mineral estate or in contiguous mineral estates to voluntarily pool their interests and to share expenses incurred in oil and gas exploration. More specifically, Form 610 provides for the designation of an operator, who shall be in charge of all production

70. TENN. CODE ANN. § 36-820(a)(3) (1977).

operations, and nonoperators, who shall be liable for their proportionate share of the expenses incurred by the operator.¹

The operator is primarily liable for the payment of expenses incurred in the exploration and development of the mineral estate covered by the operating agreement.² By the terms of Form 610, the operator is under a contractual duty to discharge these costs promptly and then bill the nonoperators for their proportionate share of the expenses.³ Unless the operator asks for advance payment, the operator must extend credit to the nonoperators and rely upon their willingness and ability to reimburse their share of expenses.⁴

To ensure reimbursement from the nonoperators, the operator is granted the power to collect directly from the purchaser of the oil and gas the proceeds from the sale of the nonoperators' share of oil and gas produced until the amount owed by them, plus interest, has been paid.⁵ In addition, under article VII-B, each nonoperator grants to the operator "a lien upon the oil and gas rights in the Contract Area, and a security interest in its share of oil and/or gas when extracted"⁶

The purpose of this note is to examine the applicability of article 9 of the Uniform Commercial Code (Code) and the existence of other liens and security interests under the Model Form Operating Agreement.

Article 9 Security Interests Under the Model Form Operating Agreement

Before deciding whether article 9 of the Uniform Commercial Code applies to any security interests under the Model Form Operating Agreement, it must be determined that a security interest has been created between the parties. The term "security interest" is defined by the Code as "an interest in personal property or fixtures which secures payment or performance of an obligation."⁷ This is a broad definition and appears to apply to *any* interest that a creditor may have in the personal property or fixtures of a debtor to ensure the performance of an obligation. The scope of article 9 is not so expansive. Section 9-102(1)(a) provides that article 9 shall apply "to any transaction, regardless of its form, which is intended to create a security interest in personal property or fixtures"⁸ Thus, article 9 security interests are limited to *consensual* security interests in personal property and fixtures.

Under article VII-B of the operating agreement, the nonoperators have granted the operator an interest for the express purpose of securing payment of their share of the expenses. Consequently, the operator's lien and security

1. A.A.P.L. Form 610-1977 Model Form Operating Agreement, arts. V-A, VII-A. A.A.P.L. refers to the American Association of Petroleum Landmen.

2. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. VII-C.

3. *Id.*

4. *Id.*

5. *Id.*, art. VII-B.

6. *Id.*

7. 12A OKLA. STAT. § 1-201(37) (1981).

8. 12A OKLA. STAT. § 9-102(1)(a) (1981).

interests meet the preliminary qualifications for an article 9 interest in that they are created by agreement between the parties and exist to ensure that the operator receives reimbursement for expenses made on behalf of the nonoperators' interests. Thus there are two potential security interests granted to the operator: (1) the security interest in the nonoperators' share of oil and gas "when extracted," and (2) the "lien" upon the oil and gas rights of the nonoperators.

An operator wishing to claim an article 9 security interest in the oil and gas "when extracted" also must show that it is an interest in personal property.⁹ It is commonly stated that article 9 does not apply to oil, gas, and other minerals before extraction.¹⁰ Once extracted, however, the oil and gas become personalty and subject to the provisions of article 9.¹¹ The operator also may rely on section 9-204, which allows the use of after-acquired property as collateral to secure the performance of the nonoperators' present obligations to the operator.¹²

It is not as clear, however, whether the operator can claim a security interest under the Code in the nonoperators' "oil and gas rights." Article 9 does not apply to the creation or transfer of an interest in or lien on real estate.¹³ The ambiguity arises from the fact that a nonoperator's "oil and gas rights" usually consist of an oil and gas leasehold that is difficult to classify as either real property or personal property.

The confusion results from the Oklahoma Supreme Court's reference to an oil and gas lease as a chattel real, an incorporeal hereditament, a *profit a prendre*.¹⁴ These terms are not synonymous, however. A chattel real is "personal property, an incorporeal hereditament is real property, and a profit a prendre may be either real property or personal property depending on its duration."¹⁵ Subsequent cases, however, appear to be consistent in their holdings, if not in the language used.

In *Cuff v. Koslosky*,¹⁶ the Supreme Court of Oklahoma stated:

The undeveloped oil and gas lease is limited to a definite fixed term of years or months, and an estate so acquired by conveyance and limited to a fixed and definite term, even though a freehold, is a chattel real. It lacks indeterminate duration, and a chattel real such as an oil and gas lease passes at death to the personal representatives and not to the heirs.¹⁷

As a chattel real, the oil and gas lease is personalty. This does not mean,

9. 12A OKLA. STAT. § 9-102 (1981).

10. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 890 (2d ed. 1980).

11. *Id.*

12. 12A OKLA. STAT. § 9-204 (1981).

13. 12A OKLA. STAT. § 9-104(j) (1981).

14. See Rich v. Doneghey, 71 Okla. 204, 206-07, 177 P. 86, 89 (1918).

15. Emery, *Real Property Mineral Interests in Oklahoma*, 24 OKLA. L. REV. 337, 347 (1971).

16. 165 Okla. 135, 25 P.2d 290 (1933).

17. *Id.* at 137, 25 P.2d at 293.

however, that it is not an estate in real property. An oil and gas lease is a chattel real, which is personalty, and at the same time it is an estate in real property.¹⁸

When faced with a statute that applies to "interests in real property," the Oklahoma courts have been consistent in holding an oil and gas lease to be within that term, but cite two seemingly contradictory holdings. For example, in *Nicholson Corp. v. Ferguson*,¹⁹ the court held an oil and gas lease was a grant "of an estate in real property" within the meaning of such phrase in a statute relating to the measure of damages for breach of covenants of title. On the other hand, in *First National Bank v. Dunlap*,²⁰ the court held that a statute granting a judgment lien upon the *real estate* of the debtor did not apply to an oil and gas lease. The court focused on the statutory language placing the lien on the real estate of the debtor. Since the statute did not speak of "an interest in real estate," it did not apply to an oil and gas lease.

An examination of section 9-104, which describes transactions outside the scope of article 9, reveals that it does not apply to "the creation or transfer of an interest in or lien on real estate"²¹ The language of this section is almost identical to previous statutory language held to encompass an oil and gas leasehold.²² In conclusion, the Oklahoma courts have used conflicting and confusing terminology in defining an oil and gas leasehold. Fortunately, the Oklahoma Supreme Court clearly has stated that the interest created by the oil and gas lease is an "interest in real property,"²³ and as such is excluded expressly from the scope of article 9 by section 9-104(j). However, the operator still has a valid article 9 security interest in the oil and gas "when severed."

The Model Form Operating Agreement as a Security Agreement and Financing Statement

Section 9-203 of the Code provides that security interests are not enforceable and do not attach to the collateral unless: (1) the debtor has signed a security agreement which contains a description of the collateral; (2) value

18. *First Nat'l Bank v. Dunlap*, 122 Okla. 288, 254 P. 729 (1927). See Oklahoma Simplification of Land Titles Act, 16 OKLA. STAT. § 61(a) (1981): "An interest in real estate shall include, but not be limited to mortgage liens, interests of purchasers under contract of sales, leases, easements, oil and gas leases, and mineral and royalty interests."

19. 114 Okla. 16, 243 P. 195 (1925).

20. 122 Okla. 274, 254 P. 729 (1927).

21. 12A OKLA. STAT. § 9-104(j) (1981) (emphasis added).

22. See, e.g., *Nicholson Corp. v. Ferguson*, 114 Okla. 16, 243 P. 195 (1925) (held an oil and gas lease is a "grant of an estate in real property" under the terms of a statute relating to the measure of damages for breach of covenants of title); *Woodworth v. Franklin*, 85 Okla. 27, 204 P. 452 (1922) (held an oil and gas lease to be included within the Statute of Frauds, which covered "an agreement for the leasing for a longer period than one year, or for the sale of real property, or of an interest therein"), citing 1910 Rev. Laws § 941; 1 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 214.2 at 167 (1981).

23. *Cuff v. Koslosky*, 165 Okla. 135, 139, 25 P.2d 290, 294 (1933).

has been given; and (3) the debtor has rights in the collateral.²⁴ Failure to comply with these basic requirements completely invalidates the security interest.²⁵

Under the Model Form Operating Agreement, the operator is granted a security interest in the nonoperators' share of oil and gas "when extracted." The operator may meet the requirements of section 9-203(1) by filing a separately executed security agreement. It is contended, however, that this is not necessary as a properly executed Model Form Operating Agreement will meet all of the requirements for a valid security agreement.

Although the description of the collateral is necessary, the description is sufficient "whether or not it is specific if it reasonably identifies what is described."²⁶ Consequently, a blanket or general description often will be sufficient.²⁷ Under the operating agreement, the well site is described and the collateral clearly is described as the nonoperators' share of oil and/or gas produced from the designated well. Since creditors clearly can identify which quantities of oil or gas are being placed as collateral for the security interest, the operating agreement contains a sufficient description of the collateral to meet the requirements of section 9-203(1).

An additional requirement for a valid security agreement is that value be given for the security interest. Section 1-201(44) of Title 12A provides that "a person gives 'value' for rights if he acquires them (a) in return for a binding commitment to extend credit . . . or (d) generally, in return for any consideration sufficient to support a simple contract."²⁸ Both elements of value exist in the operating agreement. The operator extends credit to the nonoperators by personally paying all drilling and production expenses and billing them for reimbursement at a later date. Additionally, under the terms of the agreement, the operator is personally liable for the payment of the entire expense of the well. This assumption of personal liability constitutes a detriment to the operator and is sufficient to support a simple contract.

Finally, the debtor must have rights in the collateral. The parties to the operating agreement are typically lessees in an oil and gas lease and as such have the right to go in and produce the oil and gas under the leasehold. However, once the oil and gas are produced, the lessees have vested ownership interests in the oil and gas, which is now personal property, subject to the payment of royalties to the mineral estate. Thus, at the time of the execution of the operating agreement, the nonoperators do not have existing rights in personal property. Under section 9-204, however, they may create a "floating lien" on after-acquired collateral that will attach as soon as the oil and gas are severed from the realty and become personal property. It is not

24. 12A OKLA. STAT. § 9-203(1) (1981).

25. *Id.*

26. 12A OKLA. STAT. § 9-110 (1981).

27. WHITE & SUMMERS, *supra* note 10, at 910-12.

28. 12A OKLA. STAT. § 1-201(44)(a), (d) (1981).

“after-acquired collateral” in the sense that the nonoperators do not have existing rights in the oil and gas. However, the nonoperators’ rights are “after-acquired” in the sense that as the oil and gas are produced, their interests will be transformed from interests in realty to interests in personal property to which a security interest can attach.

The operating agreement meets the requirements of section 9-203 for the enforceability of a valid security interest. Upon execution of the operating agreement by the nonoperators, the operator’s security interest has “attached,” and the operator has a presently enforceable interest against any production from the well designated in the operating agreement.

Under the Code, “perfection” or “filing” allows a perfected secured party to gain priority over parties who subsequently obtain security interests in the collateral.²⁹ Thus, by filing notice of his security interest in the oil and gas when severed, the operator gains priority over other subsequent security interests. To gain priority, the operator must file a financing statement. Although specific financing statement forms exist, it is contended that the Model Form Operating Agreement may be used for this purpose.

Under section 9-402, a filed financing statement is sufficient if it: (1) gives the names of the debtor and the secured party; (2) is signed by the debtor; (3) gives an address of the secured party; (4) gives a mailing address of the debtor; and (5) contains a statement indicating the types or describing the items of collateral.³⁰

The Model Form Operating Agreement lists the names of the nonoperators, is executed by them, and contains a description of the collateral; that is, it describes the collateral as the oil and gas “when severed” from the contract area covered by the operating agreement. It would be a small matter to add the addresses of the operator and the nonoperators and consequently meet all of the usual requirements for a financing statement.

The Model Form Operating Agreement grants a security interest in oil and gas. A financing statement covering oil and gas is subject to additional requirements under section 9-402(5): “A financing statement covering . . . minerals or the like (including oil and gas) . . . must show that it covers this type of collateral, must recite that it has to be filed in the real estate records, and the financing statement must contain a description of the real estate”³¹ The Model Form Operating Agreement customarily contains a full legal description of the land covered by the agreement and provides notice of a security interest in oil and gas produced from that land. However, the operating agreement does not provide that it is to be filed in the real estate records. Again, such a provision may be added by the operator. Once such a recitation is added, the operating agreement qualifies as a valid financing statement.

29. 12A OKLA. STAT. § 9-312(5) (1981).

30. 12A OKLA. STAT. § 9-402 (1981).

31. *Id.*

The Oil and Gas Well Lien Statute

Once a timely perfection has been made, the operator's article 9 security interest in the nonoperators' share of severed oil and gas can be an effective device to ensure reimbursement to the operator. However, this remedy is only useful if there is actual production to which the security interest may attach. Drilling operations frequently result in dry holes with no production to satisfy the operator's claims against a defaulting nonoperator. The operator must then look to other available assets of the nonoperator.

Normally a dry hole will greatly reduce the value of a leasehold interest. Yet, often an unproductive oil and gas well is the result of engineering and technical difficulties rather than the absence or presence of oil or gas. As a result, the nonoperator's leasehold interest in the unsuccessful program may still have considerable speculative value. The operator may wish to resort to any remedies available to him in order to reach that leasehold interest.

It was noted previously that the Model Form Operating Agreement grants the operator a lien on the nonoperators' "oil and gas rights in the Contract Area."³² Even though the Code does not apply, the operator may have another lien that it can use to reach the nonoperators' leasehold interest. The Oklahoma legislature has provided that liens are created by contract or by operation of law.³³ The operator may thus argue that in addition to a contractual lien, it qualifies for the statutory lien granted in the oil and gas well lien statute, section 144 of Title 42.³⁴

Section 144 states that "any person, corporation, or co-partnership who shall, under contract, express or implied, . . . perform labor or services . . . used in the digging, drilling, torpedoing, completing, operating, or repairing of any oil or gas well . . . shall have a lien upon the whole of such leasehold . . ."³⁵ The statute also gives this lien priority over all other liens that arise subsequent to the date of the first performance of the labor or services in connection with the operation of an oil and gas well.³⁶

To assert a lien under section 144, there must first be a contract to furnish labor or services.³⁷ The requirement that there be a contract between the parties is easily met. The Model Form Operating Agreement is an express agreement between the parties that provides a contractual framework for the joint development of oil and gas properties. Whether the operator renders "services" within the meaning of section 144 is a more difficult question to answer.

The definition of "services" under section 144 has never been addressed explicitly by the Oklahoma Supreme Court. The statute includes services arising from a written contract for the services of a geologist or petroleum engineer. This indicates that acts other than manual labor on the well site will

32. See *supra* text accompanying note 6.

33. 42 OKLA. STAT. § 6 (1981).

34. 42 OKLA. STAT. § 144 (1981).

35. *Id.*

36. *Id.*

37. *Pace v. National Bank of Commerce*, 190 Okla. 503, 125 P.2d 178 (1942).

qualify for the oil and gas well lien. Similarly, the operator has extensive managerial powers over the development of the nonoperators' leaseholds. For example, the operator contracts with suppliers and is responsible for promptly discharging all debts incurred even if the operator has not received reimbursement from the nonoperators. The operator is under an obligation to conduct the operations in a "good and workmanlike manner," to make reasonable tests of all formations, to draft and prepare pooling designations, and to conduct any necessary hearings before governmental agencies to secure pooling and spacing orders.

These managerial functions, as well as the assumption of primary liability, place a heavy burden on the operator. They also directly serve to facilitate the development of the nonoperators' leasehold interests. It is difficult to see a distinction between the quality of benefits resulting from the services of a geologist or petroleum engineer and the vital managerial and administrative functions of the operator under the Model Form Operating Agreement.

In *Diffenbach v. H. H. Mahler Co.*,³⁸ the Supreme Court of Oklahoma indicated that certain managerial functions qualified as "labor" within the mechanic's lien statute. In that case, the H. H. Mahler Company had contracted with the defendant to complete working drawings and specifications for the construction of a building, to order materials; to hire and direct labor, and to organize and direct all branches of work. The court held that the term "labor" is not confined to physical or manual labor and that the mechanic's lien statute was broad enough to encompass the action on the contract.³⁹ The holding of *Diffenbach* provides persuasive authority for the proposition that the services performed in the operation of an oil and gas well are within the "labor and services" provision of section 144 of Title 42.

An additional requirement under section 144 is that the services must be performed "in connection with" the development of an oil and gas well. This implies a reasonable connection between the services performed and the benefits accruing to the oil and gas leasehold. Many of the services provided by the operator are performed away from the well site. Again, the addition of the word "services" and the provision granting a lien for the services of a geologist or petroleum engineer—which are also frequently performed some distance from the actual well site—indicate the legislature's intent not to limit the protection of section 144 solely to laborers working directly on the well and equipment companies that provide machinery used on the well location. The services provided by the operator are essential to the smooth and economical development of oil and gas property jointly owned by numerous parties.

If the operator contracts with third parties to drill an oil and gas well for the common benefit of itself and the nonoperators, and the operator remains unreimbursed for the expenses it has incurred, then the operator has extended credit to the nonoperator for the payment of labor and materials that went directly toward the improvement of the nonoperators' interests.

38. 167 Okla. 518, 30 P.2d 907 (1934).

39. *Id.* at 519, 30 P.2d at 908.

The services provided by the operator, as well as the extension of credit to defaulting nonoperators, have a direct relationship to the development of the nonoperators' oil and gas interests in the well and should come under the requirements of section 144.

Although it is true that an operator has other remedies under the Model Form Operating Agreement to obtain reimbursement for expenses, the operator may find a more effective remedy in the lien granted by section 144, especially in the event of drilling operations that are not productive because of engineering or equipment breakdown.⁴⁰ A defaulting nonoperator may not have sufficient funds to pay for expensive reworking operations. Consequently, the operator will wish to obtain a high priority lien upon the nonoperator's leasehold interest. Fortunately, the section 144 lien is given priority over all liens and encumbrances that attach "subsequent to the date of the furnishing of the first item of material or the date of the performance of the first labor or services."⁴¹ The operator performs many services that affect the oil and gas leasehold even before drilling operations have begun, such as contracting for the services of a drilling rig and obtaining the necessary pooling and spacing orders.

The operator may also wish to resort to section 144 rather than perfecting an article 9 security interest in the oil and gas once it has been severed from the realty. Section 144 allows a lien on the "proceeds from the sale of oil or gas produced therefrom inuring to the working interest" The operator's priority to such proceeds will also date back to the date of the first performance of services in connection with the drilling and operation of the well.

Conclusion

The operator has several effective remedies under the Model Form Operating Agreement to secure reimbursement from the nonoperators. The operator may perfect an article 9 security interest in the oil and gas produced from the nonoperators' leasehold interest. Although it might be advisable for all parties to execute a separate security agreement and financing statement at the time of the execution of the operating agreement, it is contended that this is not necessary. The Model Form Operating Agreement meets all of the requirements for both a security agreement and a financing statement. If the operator sees a need to perfect his security interest, a prompt filing of the operating agreement in the appropriate records of the county in which the leasehold interest is located will meet the requirements for perfection under article 9 of the Uniform Commercial Code.

In the event of no production, the operator is in a weaker position. He might be able to assert an oil and gas well lien under section 144 of Title 42 and levy against the value of the defaulting nonoperators' leasehold interests. This is also an effective remedy given the high priority that this statutory lien has over other claims to the proceeds from the oil and gas produced.

Randall Wood

40. 42 OKLA. STAT. § 144 (1981).

41. *Id.*