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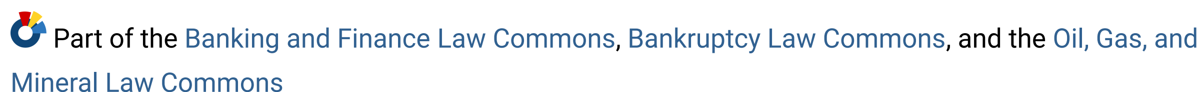
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The Curious Policy Implications of In re SemCrude: Do Crude Oil Markets Need a Volcker Rule?

By Joseph A. Schremmer

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In the summer of 2008 the nation's largest and fastest growing midstream crude oil purchaser, SemCrude, declared bankruptcy. SemCrude's demise was not the result of a bear market—crude oil traded on the NYMEX at $147 per barrel the month SemCrude filed—but of its taste for risky options trading. The bankruptcy pitted the competing liens of thousands of unpaid oil and gas producers and royalty owners who sold their crude oil to SemCrude at the wellhead against those of SemCrude's lenders and the claims of downstream purchasers. Producers from Texas, Kansas, and Oklahoma claimed prior perfected security interests and statutory liens under various nonuniform state amendments to Article. These were adopted specifically to protect producers from the insolvency of crude oil purchasers. The Bankruptcy Court for the Federal District of Delaware, however, found none of the producers' lien rights to be perfected under applicable law and awarded priority to SemCrude's lenders. Producers and royalty owners were left holding the bag.

The dust has all but settled since the Third Circuit's July 2017 decision in In re SemCrude, 864 F.3d 280 (3d Cir. 2017), affirming the Delaware Bankruptcy Court's ruling and further awarding priority to downstream purchasers of the oil over the producers. Yet little has been written about the decision's implications for the broader crude oil market. Only Oklahoma has acted to fix the flaw of its statutory lien identified in the litigation. And no one has attempted to reconcile the policy of the Third Circuit's decision—preservation of the free, unencumbered flow of crude oil in downstream commerce—with the rights and expectations of upstream crude sellers.

This brief piece does not resolve the dilemma. It only hopes to frame the issue as a problem of systemic market risk like what ailed the financial sector preceding the 2007 financial crisis. As with the financial crisis, this problem may be solvable partly by restricting speculation by midstream crude oil and natural gas purchasers similar to how regulators restrict speculation by federally insured banks under § 619 of the Dodd-Frank Act, known as the "Volcker rule."

A Snapshot of the Crude Oil Market

Crude oil's path from underground to a gas tank involves many buyers and sellers. Mineral owners own the real property where the oil is originally in place. Because

mineral owners generally lack the capital and expertise to extract the oil, they lease the land to specialized firms in exchange for a cost-free royalty, granting the lessee the right to produce and sell the oil. Oil producers contract with third-party purchasers to sell the produced crude. These buyers, called "midstream" companies, arrange for transportation of the oil (usually by pipeline) and sell it to downstream buyers to be refined and eventually retailed to end users. Midstream companies typically make a modest margin on transporting the product. At each step of the way sellers take the product on credit and make payment usually on the twentieth day of the following month.

Midstream companies commonly hedge the value of the crude oil in their transportation systems by acquiring put options—the right to sell the oil at a specified price on a future date—to ensure they don't have to resell the oil for a loss. SemCrude, instead, sold call options giving the buyer the right to purchase oil from SemCrude at a specified price at a future date, essentially betting the price of oil would drop. In re SemCrude, 864 F.3d at 287. In an effort to grow profits quickly SemCrude took an enormous position in these options. As the price of oil kept rising SemCrude kept losing its bets and took additional loans to double down. It eventually buckled under margin calls. When it failed, SemCrude lacked the cash to pay producers for oil it purchased the previous month.

In re SemCrude in a Nutshell

Oil producers have endured midstream bankruptcies before. As a consequence, several oil and gas producing states (e.g., Texas, Oklahoma, Kansas, North Dakota, and New Mexico) have laws giving producers a lien in crude sold to the first purchasers to secure payment. Texas and Kansas, for example, include a nonuniform provision in their versions of Article 9 granting producers an automatically perfected purchase money security interest in production. See Tex. Bus. & Com. Code § 9.343; Kan. Stat. Ann. § 84-9-339a. Oklahoma law provides a statutory lien in favor of producers. 52 Okl. St. Ann. § 549.1, et seq. In the SemCrude bankruptcy, producers from these states asserted that liens perfected under their respective nonuniform state laws obtained priority over SemCrude's lenders and downstream purchasers.

The Delaware Bankruptcy Court disagreed. Essentially the court found that under both Texas's and Kansas's versions of Article 9 perfection of the nonuniform PMSI was determined by the laws of the states where the debtors (SemCrude and its affiliates) were located—in this case, Oklahoma and Delaware. The drafters of revised Article 9 intend the uniform choice of law provision to eliminate uncertainty about how to perfect and where to file and search for financing statements. Neither Oklahoma nor Delaware adopted the nonuniform PMSI. Thus, the only means of perfecting the producers' security interests was to file a financing statement in the central filing office of the debtors' location; none of the producers had done so. As for the producers claiming priority under an Oklahoma statutory lien, the court simply noted the statute expressly subordinated the lien to Article 9 security interests.

The Third Circuit affirmed the lower court's ruling and reasoning. For procedural reasons the appellate panel also held that the producers' security interests and liens

were subordinate to the rights of downstream purchasers of the crude oil that enjoyed status as buyers for value and buyers in the ordinary course. The most striking aspect of the Third Circuit's opinion is its commentary on the nature of the downstream oil and gas market and the importance of keeping it free from sellers' encumbrances. "The oil industry operates through sales on credit. . . . The industry thus uses the Conoco warranty that this oil is sold free and clear of any liens because it is a hard-to-trace, liquid asset that flows throughout the country." Id. at 300. The court continued, "In sum, if any producer of oil tries to sell it subject to a security interest . . . that flows endlessly down the stream of commerce, it will be unsold. The Producers' contention that a lien . . . follows oil from their wells to the gas pump does not make sense for this type of market." Id. at 301.

The Volcker Rule as a Model Solution

On the one hand, producers and royalty owners shouldn't have to bear the risk of purchasers' insolvency unsecured. But on the other hand, assuming the Third Circuit's logic holds, the free flow of oil in the downstream market depends on it being sold on credit unencumbered by liens and security interests. Resolving this dilemma requires addressing the source of the problem—the midstream firm's insolvency. Crude oil and natural gas transportation companies routinely hedge the value of their crude oil to ensure they recoup their investment in it plus overhead and reasonable profit. But when does routine hedging become SemCrude-style speculation? According to Professor Emeritus Paul MacAvoy, it's "[w]hen you have a large open short position and not enough physical barrels to cover your short when the contracts expire." Another way midstream companies like Semcrude can get in trouble is to venture beyond mere futures contracts intended to hedge into call options intended to profit.

Dodd-Frank's Volcker rule prohibits federally insured banks and their affiliates from engaging in proprietary trading and investing in hedge funds to limit the risk of failure of large financial institutions. The rule isn't without critics both for its drafting and its unintended consequences. Regardless it is the intent of the rule more so than the rule as written that provides a model for regulating midstream crude markets. That intent, according to the rule's namesake Paul Volcker, is to reduce systemic risk to the financial system by limiting high-risk trading activities by key banking institutions.

A federal rule designed to limit high-risk trading by midstream oil and gas firms would reduce the risk of their insolvency. It would thus mitigate the largest risk facing producers of oil and gas in terms of payment for their product. Accordingly, it would reduce the compulsion oil and gas producing states feel to protect producers and royalty owners through nonuniform statutory liens and UCC provisions that might clog the otherwise free flow of oil in downstream commerce. Oklahoma's reaction to In re SemCrude, for example, has been to patch its statutory lien to prioritize it above Article 9 security interests. Other states are likely to follow suit unless a more efficient solution to systemic risk is found.

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