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2017

# Oil and Gas Secured Transactions in Kansas

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### Recommended Citation

Joseph A. Schremmer, *Oil and Gas Secured Transactions in Kansas*, November/December The Journal of the Kansas Bar Association 23 (2017).

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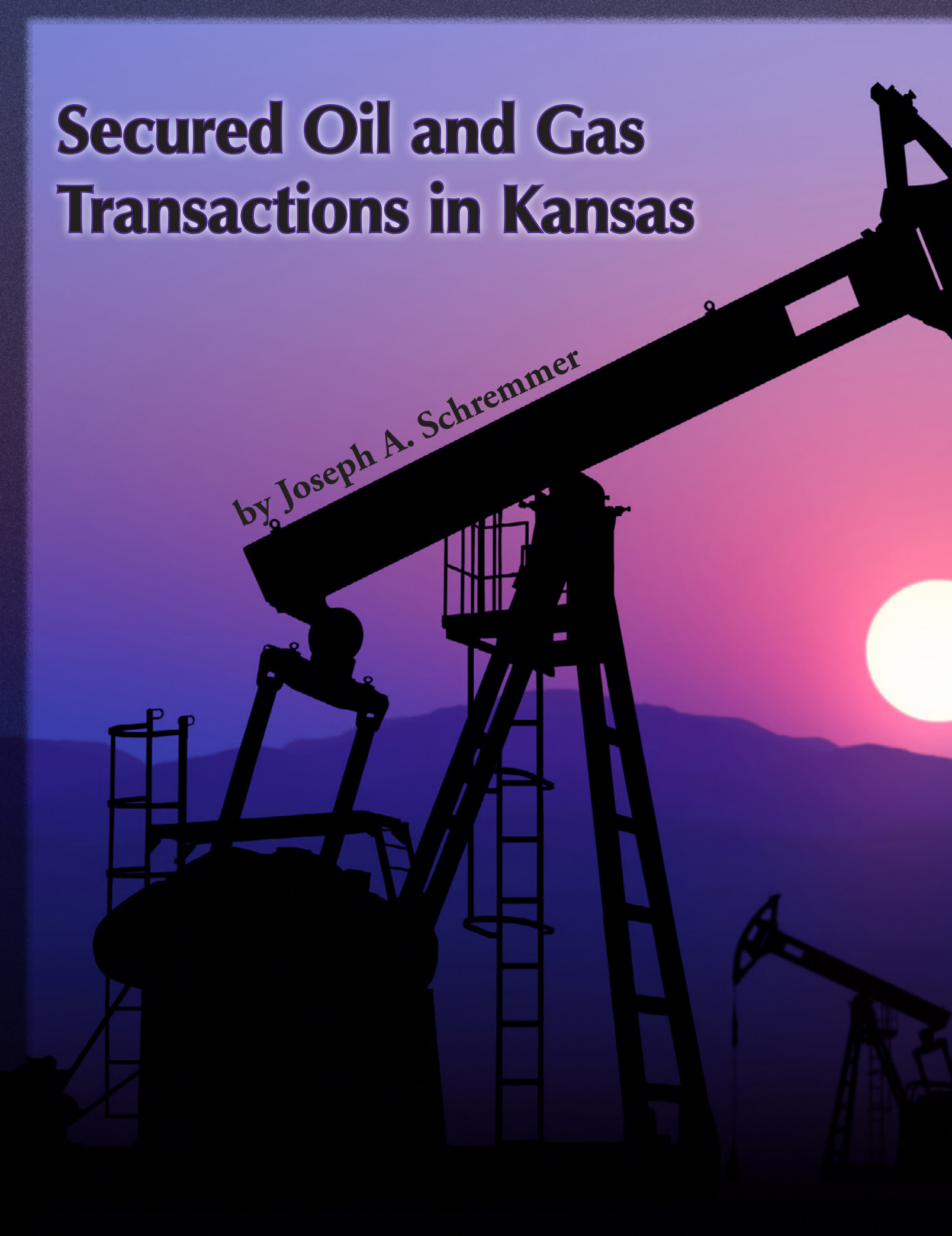


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# Secured Oil and Gas Transactions in Kansas

by Joseph A. Schremmer



## I. Introduction

Oil and gas financing in Kansas is common, but not commonsense.<sup>1</sup> Often the complexities become apparent after the price of oil has fallen and lenders must defend the priority of their claims in bankruptcy and foreclosure proceedings. Successfully handling oil and gas secured transactions in Kansas requires understanding two bodies of law: Article 9 of the Kansas Commercial Code (Article 9 or UCC) and Kansas real property law. This article surveys the creation, perfection, priority, and enforcement of consensual liens in oil and gas property under both sets of rules. Liens under joint operating agreements and statutory oil and gas liens are outside the scope of this article.<sup>2</sup>

A secured transaction is a business arrangement by which a borrower gives collateral to the lender to guarantee payment of an obligation.<sup>3</sup> The lender's interest in the collateral is a lien, in this case a consensual lien.<sup>4</sup> A lien lasts until the debt or duty it secures is performed.<sup>5</sup> A lien attaches only to the debtor's interest in the collateral.<sup>6</sup> The lienholder can enforce it by taking or selling the collateral in satisfaction of the debt if the debtor defaults on its obligation.

In Kansas, consensual liens in real property are called *mortgages*, while those in personal property are *security interests*. Article 9 governs security interests in personal property and fixtures.<sup>7</sup> Kansas real property law governs mortgages in real property.<sup>8</sup> Oil and gas lending implicates both security interests and mortgages because the collateral in an oil and gas transaction generally include real and personal property. Oil and gas property, such as oil and gas leases, wells, production equipment, and related contracts, are more valuable when integrated together in a producing lease or unit. Because the producing unit's value is greater than the sum of its parts, lenders want to secure exploration and production operating loans with liens on all the property necessary to operate the unit in the event of default. If the lender has to foreclose, it can repossess all the property necessary to operate the producing unit and sell it together for more than it would bring piecemeal.

The components typically needed to operate the producing unit include the debtor's interest in the oil, gas, or other minerals in place and as produced and any proceeds of production; oil and gas lease or leases; oil, gas, and injection

wells; surface and downhole equipment for producing, treating, and storing oil and gas; oil and gas gathering and transmission pipelines; and associated contracts such as oil or gas purchase contracts and operating and exploration contracts. Debtors in the oilfield services sector tend to offer moveable equipment like drilling and well-servicing rigs as collateral. This list is not exclusive. Parties to oil and gas financing transactions often execute an instrument (commonly called a "Mortgage, Security Agreement, and Financing Statement") describing all of the above property as well as general categories like "all other real and personal property of the debtor."

## II. Attachment: Creating a Lien

A lien must first attach in the collateral to be enforceable. The term *attach* is used "to describe the point at which property becomes subject to a security interest."<sup>9</sup> Under Article 9, a security interest attaches when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment.<sup>10</sup> A security interest is considered enforceable against the debtor, and third parties, with respect to the collateral when value has been given; the debtor has rights in the collateral or the power to transfer rights in the collateral to the secured party; and the debtor has authenticated a security agreement that describes the collateral or possession of the collateral is in the secured party under the security agreement.<sup>11</sup>

A lien in real property is effective when the debt arises and a written instrument creating a lien in the real property, typically a mortgage, is signed by the owner of the property (the mortgagor).<sup>12</sup> There are otherwise no special formalities to create a mortgage in real property.<sup>13</sup> In addition to satisfying these basic formal requirements, security agreements and mortgage agreements usually define the parties' respective rights and obligations as to the collateral, define the events of default by the debtor, and circumscribe the secured party's enforcement rights. Section V on lien enforcement describes certain provisions often included in security and mortgage agreements for these purposes.

## III. Perfection of Liens and the Effect of Perfection or Nonperfection

Perfecting a mortgage or security interest in oil and gas property is necessary to give notice to and maintain priority over subsequent lienholders and purchasers of the property.

Correctly classifying the property serving as collateral is crucial to proper perfection. Drafters must first determine whether the intended collateral is real or personal property. That determines the applicable body of law.<sup>14</sup> Article 9 controls security interests in collateral that is personal property and fixtures.<sup>15</sup> Non-UCC Kansas real property law controls perfection of mortgages in real property.<sup>16</sup> Perfecting a mortgage in real property in Kansas is fairly straightforward. Under Kan. Stat. Ann. § 58-2221, the mortgagee must record the written instrument creating the mortgage, signed by the mortgagor, in the office of the register of deeds for the county where the property is located.<sup>17</sup> Recording provides constructive notice of the mortgage to the public.<sup>18</sup> Unless and until recorded, the mortgage is only enforceable between the parties.<sup>19</sup>

### A. Article 9 and Choice of Law

For security interests in personal property and fixtures, determining the manner of perfection under Article 9 is more complex. The first issue is to determine which state's version of Article 9 applies. Under Kan. Stat. Ann. § 84-9-301(1), the law of the location of the debtor generally controls perfection, the effect of perfection or nonperfection, and the priority of security interests. But the law of the jurisdiction in which the wellhead is located governs the manner and effect of perfection and the priority of a security interest in as-extracted collateral (oil and gas, discussed below), regardless where the debtor is located.<sup>20</sup> Under revised Article 9, the perfection of a security interest in goods (a particular type of collateral, discussed below) is governed by the law of the debtor's location, but the effect of perfection or nonperfection and the priority of security interests in goods is determined by the law of the location of the goods.<sup>21</sup> The drafters of the 2000 revisions to Article 9 intentionally divorced the question of perfection from the effect of perfection or nonperfection and relative priorities of security interests in goods in order to address situations where goods owned by an out-of-state debtor, but located in Kansas, become subject to a non-UCC Kansas statutory lien (e.g., an execution lien or oil and gas mechanic's lien). When that happens, the law of the debtor's location determines whether the security interest is properly perfected, but Kansas law determines the relative priority of the security interest and the statutory lien.<sup>22</sup>

### B. Methods of Perfecting Article 9 Security Interests

Once we determine which state's Article 9 applies, the next issue is how to perfect a security interest in the collateral under that law. This issue requires classification of the collateral. Article 9 requires different manners of perfection for different collateral classifications. The most common types of collateral in oil and gas transactions are goods, equipment, fixtures, accounts, and as-extracted collateral. *Goods* are "all things that are movable when a security interest attaches."<sup>23</sup> Goods other than inventory, farm products, or consumer goods are considered *equipment*.<sup>24</sup> *Fixtures* are another subcategory of goods.

Fixtures are defined as goods "that have become so related to particular real property that an interest in them arises under real property law."<sup>25</sup> Goods specifically do not include oil, gas, or other minerals before extraction.<sup>26</sup> *Accounts* are rights to payment of a monetary obligation for, among other things, property that has been sold or services rendered.<sup>27</sup> *As-extracted collateral* is a special category created specifically for oil and gas and mining transactions, and is discussed in detail below.

There is often uncertainty in classifying common types of oil and gas collateral for perfection purposes, which begets uncertainty in how to properly perfect a lien in those types of collateral. The remainder of this section discusses the classification of typical collateral in oil and gas transactions. Table A summarizes the primary method of perfection for common collateral types.

#### 1. Liens in Oil, Gas, or Other Minerals as Produced

Oil, gas, or other minerals that have not been extracted, *i.e.*, that are in place in the ground, are specifically excluded from Article 9's definition of goods.<sup>28</sup> Official Comment 4 to Kan. Stat. Ann § 84-9-102 explains that "oil, gas, and other minerals that have not been extracted from the ground are treated as real property, to which this Article does not apply." A lien in oil, gas, or other minerals in place is thus a mortgage in real property and is perfected under Kan. Stat. Ann. § 58-2221 by recording the signed mortgage instrument in the office of the register of deeds for the county where the land is located.

Once extracted however, oil, gas, or other minerals become personal property, specifically goods, that are subject to Article 9. When produced, oil and gas is goods for a brief moment, but then becomes inventory (goods held for sale). The oil and gas is transformed into accounts (rights to payment) in the hands of the producer once it is actually sold, only to then become identifiable cash proceeds once payment is received by the debtor for the sale.<sup>29</sup> All of these transformations occur quickly. To deal with the ephemeral nature of extracted oil or gas, revised Article 9 creates a special category of collateral called *as-extracted collateral*, defined as

- (A) Oil, gas, or other minerals that are subject to a security interest that:
  - (i) is created by a debtor having an interest in the minerals before extraction; and
  - (ii) attaches to the minerals as extracted; or
- (B) Accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which the debtor had an interest before extraction.<sup>30</sup>

*As-extracted collateral* refers to both oil and gas as it is produced and the accounts receivable created when the production is sold at the wellhead. The phrase "'at the wellhead' encompasses arrangements based on a sale of the produced oil or gas at the moment it issues from the ground and is measured, without technical distinction" as to where title passes.<sup>31</sup>



A security interest in as-extracted collateral is perfected in the same manner as security interests in fixtures, by filing a financing statement describing the collateral in the office of the register of deeds for the county where the property is located. The law of the wellhead jurisdiction governs perfection, the effect of perfection or nonperfection, and priority of a security interest in as-extracted collateral.<sup>32</sup> In other words, if the wellhead is in Kansas, Kansas Article 9 controls. Under Kansas Article 9, a lender's financing statement covering as-extracted collateral should be filed in the office of the register of deeds for the county where the wellhead is located.<sup>33</sup> The financing statement must (1) provide the debtor's name; (2) provide the secured party's name; (3) indicate the collateral; (4) indicate it covers as-extracted collateral; (5) indicate it is to be filed in the real property records; (6) provide a legal description of the real property to which the collateral is related; and (7) if the debtor does not have an interest of record in the real property, provide the name of the record owner (this would apply if the financing statement is filed before the security agreement is authenticated by the debtor).<sup>34</sup>

If it meets the requirements set forth above for financing statements and is recorded in the office of the register of deeds, a mortgage instrument may be effective as a financing statement for as-extracted collateral.<sup>35</sup> Secured creditors taking a lien in as-extracted collateral usually also take a real property lien in the debtor's interest in the underlying oil and gas leasehold. Both liens can be perfected by the filing of a mortgage that is also effective as a financing statement. The register of deeds office must accept and record a financing statement covering as-extracted collateral, and index it under the name of the debtor as if it were a mortgagor and, when other law requires it, in the numerical tract index as if it were a mortgage.<sup>36</sup> Lenders often record a single mortgage, security agreement, and financing statement, or similar document, covering both the debtor's interest in the as-extracted collateral and the oil and gas lease on the real property.

## 2. Liens in Oil and Gas Lease Interests

Ownership of an oil and gas lease is often divided into numerous distinct interests. Briefly, an owner of a mineral interest in real property owns the oil and gas in place and has the right to explore and develop the property for oil and gas production or transfer those rights to a third party.<sup>37</sup> Normally, a mineral interest owner conveys the exploration and development rights to a lessee under an oil and gas lease. Under the lease, the lessor also grants the lessee the right to all oil and gas produced but reserves as a royalty a fractional, non-cost-bearing share of the production or proceeds of production. The lessee thus owns 100% of the

leasehold interest and is entitled to all of the production from the premises less the landowner's royalty. The lessee is also responsible for 100% of the costs of production. The lessee's leasehold interest is called the *working interest*.<sup>38</sup> The lessee can convey all or part of its working interest or carve out other distinct interests from the working interest.

In Kansas, working interest is personal property.<sup>39</sup> But when perfecting a lien in working interest, or determining the effects of perfection and relative priorities of liens in such interests, working interest is treated as an interest in real property. The Kansas Supreme Court settled this issue in *Ingram v. Ingram*, when it held that "a mortgage or assignment of an oil and gas leasehold interest for security purposes is to be treated as a real estate mortgage and such instruments are not subject to the provisions of the Uniform Commercial Code."<sup>40</sup> This appears to be the majority rule among states. It is consistent with Kan. Stat. Ann. § 58-2221, which requires oil and gas leases, and instruments creating an interest in oil and gas leases, to be recorded as a real property conveyance to give notice to third parties.<sup>41</sup> A consensual lien in a working interest is therefore considered a mortgage in real property that must be perfected by recording the mortgage in the office of the register of deeds for the county where the lease is located.

Courts in other states also hold that a landowner's royalty interest created under an oil and gas lease is a real property interest for purposes of determining the manner and effect of perfection and priority.<sup>42</sup> While there appears to be no Kansas case on point, lenders treat the lessor's royalty as real property and perfect liens in such royalty interests by recording the mortgage in the appropriate register of deeds office. Lenders commonly encumber both the lessor's royalty and the lessor's mineral interest under a single mortgage instrument.





### 3. Liens in Interests Carved Out of Working Interest

To finance exploration, development, and operation of an oil and gas lease, the working interest owner often sells nonoperating interests in the oil and gas produced under the lease.<sup>43</sup> These nonoperating interests derive from the working interest. Common nonoperating interests are overriding royalty interests, production payments, and net profits interests.

An overriding royalty interest (or override) is an interest in oil and gas produced at the surface from the lease premises free of the expenses of production.<sup>44</sup> The duration of an overriding royalty interest is limited by the duration of the lease from which it is created.<sup>45</sup> Production payments (or oil payments) entitle the owner to a share of the oil or gas produced at the surface from the lease premises free of the expenses of production,

terminating when a specified sum from the sale of such oil or gas is realized.<sup>46</sup> The difference between a production payment and an overriding royalty is thus duration. A net profits interest is a share of gross production from the lease premises measured by the net profits from operation of the lease.<sup>47</sup> Like an overriding royalty, a net profits interest typically continues in duration for the life of the lease.

We treat overriding royalties, production payments, and net profits interests like interests in real property when perfecting a consensual lien in them because they are created from a real property interest (the working interest, for purposes of the manner and effect of perfection).<sup>48</sup> The customary manner of perfecting liens in overriding royalties, production payments,

and net profits interests is by recording a mortgage in the office of the register of deeds. No Kansas case appears to decide whether Article 9 or non-UCC real property law governs the means or effects of perfection or priority of liens in such interests. But, in *National Bank of Tulsa v. Warren*, the Kansas Supreme Court interpreted a statutory mortgage registration tax to apply to a production payment assignment that was given as security for a loan because the assignment was recordable as an interest affecting real property.<sup>49</sup> The court reasoned that leases are recordable as instruments affecting real property and the production payment “sprang from and owed its existence to oil and gas leases ....”<sup>50</sup> Though the interest at issue in *Warren* was not a lien in a production payment but rather the production payment itself, its rationale should apply equally to the landowner’s royalty interest, overriding royalties, and net profits interests as well.

None of these leasehold-derived interests empower the owner to set foot on the land or operate the oil and gas lease.<sup>51</sup> In many ways, these interests are more akin to a right to payment, which would be an account or general intangible subject to Article 9. Lacking controlling authority, the cautious lender may purchase the relatively cheap insurance of filing an Article 9 financing statement covering liens in leasehold-derived interests in addition to filing an assignment or mortgage with the office of the register of deeds.<sup>52</sup> Secured parties and debtors may also execute division orders which direct the first purchaser of oil or gas from a lease to make payment directly to the secured party. This practice allows the secured party to liquidate the collateral as production proceeds become due, regardless whether the debtor has defaulted.<sup>53</sup>

### 4. Liens in Wells and Equipment

A well is a borehole drilled into the earth to draw oil or gas to the surface. The term well commonly refers to the assembly of equipment associated with the borehole as well as the hole itself. The borehole is usually partially cased by steel pipe (casing) that is cemented in the hole. A wellhead is installed on the surface where the casing begins. Equipment is placed into the wellbore and on the surface to produce fluids, including oil and gas, from the borehole.

There is little guidance in Kansas law for perfecting a lien in a well. The components of a well can be either equipment (i.e., goods that are not farm goods, inventory, or consumer goods) or fixtures under Article 9, depending on the extent they are annexed to the real property. Distinguishing between personal property and fixtures can be “difficult and vexatious.”<sup>54</sup> Fixtures are personal property that has “become so related to particular real property that an interest in them arises under real property law.”<sup>55</sup> Though fixtures are real property, liens in fixtures are governed under Article 9.<sup>56</sup>

Whether personal property has become a fixture is a question of real property law. In determining this question, Kansas courts consider the property’s annexation to the real property,



its adaptation to the use of the land, and the intent of the party that annexed the property to make it a permanent annexation.<sup>57</sup> Courts look to the degree of the permanency of the property's attachment to the land to determine if it is sufficiently annexed to be an improvement to the land.<sup>58</sup> Permanency does not mean the property is immovable. Rather the controlling factor is the annexing party's intent, which is deduced largely from the party's acts and surrounding circumstances.<sup>59</sup>

One early case, *Atchison, Topeka & Santa Fe Railroad Company v. Morgan*, considered whether a railroad's steam pump, boiler, and boilerhouse used to operate a water well were fixtures or personal property.<sup>60</sup> The court held that the equipment was not fixtures because it was placed on the land to operate the owner's railroad rather than to improve the real property.<sup>61</sup> The parties in *Morgan* were the railroad and a neighbor on whose property the railroad mistakenly installed the equipment. But the court wrote in dicta that "very many authorities hold that the buckets in a well are real property ... between mortgagor and mortgagee."<sup>62</sup> *Morgan* suggests that equipment associated with oil and gas wells are likely personal property between the oil and gas lessee and lessor, but may be fixtures between the lessee and a lender with a lien in the property.

Kansas appellate courts have held that the casing in oil and gas wells is a *trade fixture*.<sup>63</sup> Trade fixtures are distinguishable from fixtures in that they do not sufficiently attach to real property to become a real property interest. They remain personal property despite their presence on the real property and, under Article 9, are most likely a category of equipment. The borehole itself is really nothing more than a hole in the ground that the lessee has a right to use for production or injection of fluids. The right to use the borehole arises from the oil and gas lease, and conceptually a lien in a borehole should be perfected in the same manner as a lien in working interest.

Lots of other equipment is necessary to produce, treat, and store oil and gas and associated substances from a cased wellbore. This includes downhole equipment such as pumps, tubing, and rods, and surface equipment like pumpjacks, engines and motors, compressors, equipment to separate produced fluids, and storage or stock tanks. Pumpjacks, or pumping units, are often cemented in place on the property and might arguably be fixtures. Stock tanks are moveable but are large, cumbersome, and often remain on the premises for long periods. These, too, can be deemed fixtures. Absent specific court decisions, it is impossible to definitively classify such surface components as fixtures or equipment. Lenders should therefore treat liens in wells and equipment as both fixtures and equipment when perfecting the liens.

Security interests in fixtures are perfected by filing a fixture filing in the register of deeds office where the real property is located in much the same manner as for perfecting a security interest in as-extracted collateral.<sup>64</sup> Security interests in equipment are perfected by filing a financing statement in the cen-

tral filing office.<sup>65</sup> The financing statement must: (1) provide the name of the debtor, (2) provide the name of the secured party, and (3) indicate the collateral.<sup>66</sup> The place for filing a financing statement covering goods, including equipment, is determined by the law of the state where the debtor is located.<sup>67</sup> If the debtor is an individual, under Kan. Stat. Ann. § 84-9-307, the debtor's place of principal residence controls. If the debtor is an organization, its place of business controls. If it is an organization with multiple places of business, its chief executive office controls.<sup>68</sup> If the debtor's location is in Kansas, Kansas Article 9 designates the office of the Kansas Secretary of State as the place for filing.<sup>69</sup>

Even though the method of perfection of an interest in equipment is governed by the debtor's location's law, the effect of perfection or nonperfection and priority are determined under the law of the jurisdiction where the *collateral* is located.<sup>70</sup> Therefore, the relative priority of a security interest in an oil or gas well and a statutory oil and gas mechanic's lien in a Kansas well would be determined under Kansas law without regard to the debtor's location (assuming the well is deemed equipment rather than a fixture).

When it is unclear whether a well or equipment should be classified as equipment or a fixture, secured parties should perfect a security interest by both filing a financing statement with the Secretary of State's central filing office and a fixture filing in the local office of the register of deeds. Recorded mortgages creating liens in an oil and gas leasehold interest may also serve as fixture filings so long as they describe the covered equipment and satisfy the other formal requirements of Kan. Stat. Ann. § 84-9-502.<sup>71</sup> Lenders may thus perfect liens in working interest, as-extracted collateral, and fixtures by the simultaneous filing of a satisfactory fixture filing. Lenders should take the additional step of filing a financing statement describing the wells and equipment with the Secretary of State's central filing office to perfect in case the collateral are later deemed goods. Lenders often file the fixture filing in the Secretary of State's office for this purpose.

## 5. Liens in Self-Propelled Equipment

Self-propelled oilfield equipment poses yet another method-of-perfection quandary. This subcategory of collateral includes things like drilling and well-servicing rigs as well as smaller tank trucks, vacuum trucks, winch trucks, fracking trucks and trailers, pickup trucks, and so forth. Rigs consist of specialized equipment designed to hoist other equipment in and out of wells. The hoisting equipment is usually fixed to a truck chassis for transportation.

The problem that arises with self-propelled collateral is whether to treat it as fixtures, equipment, or goods covered by a certificate of title. The problem is most acute with drilling and service rigs that may remain on the lease premises for extended periods, but which may be half heavy equipment and half motor vehicle. We know that security interests in fix-

tures are perfected by filing a fixture filing in the local register of deeds office<sup>72</sup> and that security interests in equipment are perfected by filing a financing statement in the central filing office.<sup>73</sup> But neither of those methods is effective to perfect a security interest in goods that are covered by a certificate of title.<sup>74</sup> Goods are deemed to be covered by a certificate of title when their owner has submitted a valid application for a certificate of title and paid the applicable fee to the appropriate state agency (here, the Kansas Department of Revenue’s Division of Vehicles) and as long as the certificate remains effective under other law.<sup>75</sup> Security interests in goods covered by a certificate of title are perfected under non-Article 9 state law—in Kansas, the Motor Vehicle Code.<sup>76</sup> In general, a security interest in certificate of title property is perfected by noting the lien on the certificate of title.<sup>77</sup>

Drilling and service rigs are often covered by certificates of title when they are attached to a truck.<sup>78</sup> If a rig is not attached to a truck, it is likely equipment (or maybe an accession).<sup>79</sup> Likewise, if a rig remains on a single lease for a long time, it could conceivably become a fixture. The very careful lender might consider perfecting its lien in that rig three ways: noting the lien on the certificate of title, filing a financing statement in the central filing office, and filing a fixture filing in the local register of deeds office. In most cases, self-propelled oilfield equipment should be considered either equipment or certificate of title property for purposes of determining the method of perfection. Perfecting by filing a financing statement in the central filing office and noting the lien on the certificate of title usually suffices to protect the lender’s interest.

**Table A: Summary of Methods of Perfecting Liens in Common Oil and Gas Property**

Property	Controlling Law	Primary Manner of Perfection (assuming Kansas Article 9 controls)
Oil, gas, or other minerals in place	Kansas real property law	Record a mortgage in the register of deeds office for the county where the property is located under Kan. Stat. Ann. § 58-2221.
Oil, gas, or other minerals as extracted	Article 9 of the wellhead state	File a financing statement that covers as-extracted collateral in the office of the register of deeds for the county where the wellhead is located under Kan. Stat. Ann. § 84-9-502(a)–(c).
Leasehold working interest	Kansas real property law	Record a mortgage in the register of deeds office for the county where the property is located under Kan. Stat. Ann. § 58-2221
Leasehold derived interests (overriding royalty, production payments, net profits interests, and landowner’s royalty)	Kansas real property law	Record a mortgage in the register of deeds office for the county where the property is located under Kan. Stat. Ann. § 58-2221. The cautious lender will also file a financing statement with the Kansas Secretary of State’s office under Kan. Stat. Ann. § 84-9-502(a).
Wells and equipment	Article 9 of the debtor’s state	If equipment, file a financing statement with the Kansas Secretary of State’s central filing office under Kan. Stat. Ann. § 84-9-502(a). If a fixture, file a fixture filing in the office of the register of deeds for the county where the property is located under Kan. Stat. Ann. § 84-9-502(a)–(b). If there is doubt which manner of perfection is appropriate, do both.
Self-propelled equipment	Article 9 of the debtor’s state or state motor vehicle law	If equipment, file a financing statement with the Kansas Secretary of State’s central filing office under Kan. Stat. Ann. § 84-9-502(a). If certificate of title property, note the lien on the certificate of title under Kan. Stat. Ann. § 8-135(c)(5)–(6). If a fixture, file a fixture filing in the office of the register of deeds for the county where the property is located under Kan. Stat. Ann. § 84-9-502(a)–(b). If there is doubt which manner of perfection is appropriate, do all that might apply.
Pipelines	Article 9 of the pipeline state	If debtor is a transmitting utility, file a financing statement with the Kansas Secretary of State’s central filing office under Kan. Stat. Ann. § 84-9-502(a). If debtor is not a transmitting utility, file a fixture filing in the register of deeds office of each county where the property is located under Kan. Stat. Ann. § 84-9-502(a)–(b). If there is doubt which manner of perfection is appropriate, do both.





## 6. Liens in Pipelines

Oil and gas pipelines are generally considered fixtures. If the debtor is a transmitting utility,<sup>80</sup> however, Article 9 spares the secured party the inconvenience of filing a fixture filing in each county where the pipeline crosses by instead permitting perfection by centrally filing a financing statement in the state where the pipeline is located.<sup>81</sup> A *transmitting utility* is a person *primarily* engaged in the business of transmitting goods by pipeline or transmitting gas.<sup>82</sup> This exception is likely unavailable when the lender takes a security interest in a pipeline owned by a debtor that is *not* primarily engaged in transmission. That security interest likely should be perfected by making a fixture filing in each county the pipeline crosses.<sup>83</sup> The most common type of pipeline in Kansas is probably a gas gathering line, which is not intended for gas transmission. Gas gathering lines generally are not owned by persons primarily engaged in gas transmission. Most financing transactions involving a gathering pipeline therefore likely require filing a fixture filing in the register of deeds office for each county where the pipeline is located.

## IV. Priorities of Competing Interests in Collateral

### A. As Against Buyers of Collateral

#### 1. Article 9's General Rules: Kan. Stat. Ann §§ 84-9-315 and 9-317

The general rule under Article 9 is that a buyer of collateral takes it subject to any security interests. Whether or not it is permitted by the parties' security agreement, a debtor's rights in the collateral may be voluntarily or involuntarily transferred.<sup>84</sup> But the terms of the security agreement remain effective as against purchasers of the collateral.<sup>85</sup> A security interest therefore continues notwithstanding sale, lease, license, exchange, "or other disposition" of the collateral, unless the secured party allows the collateral to be transferred free of the security interest.<sup>86</sup> Under Kan. Stat. Ann. § 84-9-315(a), however, a buyer of collateral takes free of the security interest if the security agreement permits transfer.

When collateral is transferred, a security interest in it automatically attaches to any identifiable proceeds of the collateral.<sup>87</sup> The secured party also has the right to repossess the collateral from the transferee. The secured party may have only one satisfaction as between identifiable proceeds and repossession of the collateral.<sup>88</sup> In appropriate cases, the secured party may maintain an action for conversion of the collateral against the transferee.<sup>89</sup> One such case is when the debtor's transfer breaches the parties' security agreement. In *Farmers State Bank v. FFP Operating Partners, L.P.*, the Kansas Court of Appeals held that a secured party had a claim for conversion of certain inventory collateral against the debtor's landlord who claimed ownership of the inventory after the debtor voluntarily abandoned her lease.<sup>90</sup> The court held that a security interest is personal property and may be the subject of a conversion,<sup>91</sup> and that the landlord, by asserting an ownership claim over the inventory adverse to the secured party's security interest, converted the inventory.<sup>92</sup>

#### 2. Buyers Not in the Ordinary Course: Kan. Stat. Ann. § 84-9-317(b).

Buyers who buy outside the ordinary course of business take subject to perfected security interests. Such buyers, however, may take free of *unperfected* security interests under Kan. Stat. Ann. § 84-9-317(b). That section states that a buyer takes free of a security interest "if the buyer gives value and receives delivery of the collateral without knowledge of the security interest ... and before it is perfected."<sup>93</sup> *Value* under the UCC includes any consideration sufficient to support a simple contract.<sup>94</sup> *Knowledge* means actual knowledge.<sup>95</sup> Actual knowledge, for UCC purposes, does not encompass facts that a person has reason to know or should know.<sup>96</sup> A transferee does not have actual knowledge of a lien merely because it has reason to know an enforceable lien might exist. Of course, when the security interest is perfected, that perfection imparts knowledge of the prior interest to the world and protects against creditors and transferees of the debtor.<sup>97</sup>

For a buyer not in the ordinary course to prevail over a lienholder, the buyer must have lacked knowledge of the existence of the security interest and have received the collateral at a moment when the security interest was not perfected. Perfected security interests can become unperfected by the lapse of time.<sup>98</sup> Thus, a buyer receiving property without knowledge of a preexisting security interest whose perfection has lapsed qualifies as a buyer not in the ordinary course under Kan. Stat. Ann. § 84-9-317(b). Staying perfected is as important as getting perfected.

Financing statements lapse automatically after five years from the filing date unless a continuation statement is filed within the last six months of the effective period.<sup>99</sup> A continuation statement is also effective for five years and may be continued in turn by filing another continuation statement.<sup>100</sup> A mortgage that is filed as a fixture filing remains effective as a financing statement until the mortgage is released or satisfied of record or its effectiveness otherwise terminates as to the real

property.<sup>101</sup> In Kansas, mortgages recorded after January 1, 1965, are effective (unless released or satisfied of record) for 42 years from the date of recording, and may be effective longer if the mortgagee timely records an appropriate affidavit.<sup>102</sup>

**3. Buyers in the Ordinary Course at the Wellhead: Kan. Stat. Ann. § 84-9-320**

Kan. Stat. Ann. § 84-9-320(e) provides a special exception for a buyer in the ordinary course of business buying oil, gas, or other minerals at the wellhead after extraction. This is a buyer that buys oil, gas, or other minerals in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person in the business of selling oil, gas, or other minerals at the wellhead.<sup>103</sup> Only if the buyer buys extracted minerals from a seller in the business can the buyer benefit from this exception. Buyers in the ordinary course take priority over an interest arising out of an encumbrance even if the encumbrance interest is perfected and even if the buyer knows it exists. Encumbrances include mortgages and other liens in real property.<sup>104</sup> Accordingly, an ordinary course buyer of oil or gas takes free of a perfected mortgage or other lien in lessor's royalty and lessee's leasehold interest (or both).

This exception protects purchasers of oil and gas from security interests created in the as-extracted collateral by the seller. Secured parties with an interest in the as-extracted collateral are nonetheless entitled to a security interest in the account arising from the sale (which is actually part and parcel of the as-extracted collateral). The security interest also attaches to identifiable cash proceeds of the as-extracted collateral.<sup>105</sup>

But ordinary course mineral buyers should be aware of a caveat.



Kansas has adopted Kan. Stat. Ann. § 84-9-339a, a non-uniform amendment to Article 9 that grants holders of interests in produced oil and gas sold at the wellhead a purchase-money security interest in the oil and gas sold, and the related proceeds, as against the first purchaser of the production.<sup>106</sup> A *first purchaser* under the statute is the first person that

purchases oil or gas production from the operator of an oil and gas lease or an interest owner in the production.<sup>107</sup> One common example of a first purchaser is a crude oil purchaser. If the purchaser pays the sale proceeds to the lease operator for distribution to other interest owners, the operator becomes the first purchaser under the statute.

Under § 84-9-339a, any signed writing that gives an interest owner a right in oil or gas production under real property law suffices as a security agreement. The first purchaser is deemed to authenticate the security agreement by issuing a division order, signing an agreement to purchase production, or making any voluntary communication with the interest owner or a governmental agency recognizing the interest owner's right.<sup>108</sup> The purchase-money security interest is deemed perfected by the filing of an affidavit of production stating that a well or wells capable of producing oil or gas in paying quantities have been completed under the oil and gas lease. Filing affidavits of production is common industry practice, and the legislature appears to have intended the § 84-9-339a purchase-money security interest to perfect almost automatically. Regrettably for producers, it doesn't always work.

Though no Kansas courts have interpreted or applied § 84-9-339a, this section received significant attention in the bankruptcy of SemCrude, L.P., a Tulsa-based Delaware limited partnership and a large purchaser of oil in Kansas. In a proceeding arising out of *In re SemCrude, L.P.*, the Third Circuit Court of Appeals held that Kansas oil and gas producers failed to perfect security interests in the crude oil they sold to SemCrude before the bankruptcy despite following the procedures of § 84-9-339a.<sup>109</sup> The court reasoned that Kansas Article 9 contains the uniform choice of law provision of § 9-301(1). Under § 9-301(1) the law of the debtor's location determines the method of perfecting a security interest in goods such as produced oil and gas.<sup>110</sup> Because SemCrude was located in Delaware, Delaware Article 9 determined the method of perfection of the producers' security interests. Delaware Article 9 lacks an analog to § 84-9-339a. As a consequence, the only method of perfecting the producers' security interests in oil sold to SemCrude was to file a financing statement in Delaware, which was not done.

This decision in *In re SemCrude* undermines the usefulness of § 84-9-339a for producers and interest owners in oil and gas because many if not most first purchasers of oil and gas are located for UCC purposes in states outside of Kansas. That ultimately raises a choice of law argument that producers will lose in every state that has adopted the uniform version of § 9-301(1), which provides that the local law of the jurisdiction in which the debtor is located governs perfection and its effects. Though it remains untested whether a purchase-money security interest in oil or gas under § 84-9-339a takes priority over competing security interests under Kansas law, it seems clear that in the case of a Kansas-domiciled debtor, the producers' § 84-9-339a rights would trump the perfected se-



curity interests of the debtor's other creditors. But, if the first purchaser<sup>111</sup> is domiciled outside of Kansas, interest owners in produced oil and gas must look to that state to determine the manner of perfecting a security interest in the production.

#### 4. Security Interests in "Abandoned" Property

Wells and equipment are sometimes abandoned by their owners, especially in times of low prices. This most often occurs following expiration of an oil and gas lease. Kansas law provides that abandoned wells and equipment vest in the owner of the real property where the wells and equipment are located.<sup>112</sup> Subsequent parties often take possession of the abandoned property, or purchase it from the landowner, and return it to operation for their own benefit. Then these parties must grapple with whether any prior security interests in the property remain enforceable.

Abandonment of collateral is a disposition by the debtor that does not cut off the secured party's interest. One court has addressed a similar issue in *Standard Dyeing & Finishing Company v. Arma Textile Printers Corporation*.<sup>113</sup> There the debtor defaulted on a loan, abandoned equipment collateral in breach of the security agreement, and surrendered its manufacturing building to its mortgagee. A third party, Arma, immediately leased the building and took the equipment. Rather than attempt repossession, the secured party sued Arma for conversion. The court held that the secured party's "security interest in the [equipment] continued to be a lien on the [e]quipment" even after the debtor abandoned it.<sup>114</sup> It further held that the secured party "properly elected its remedy of bringing an action for conversion" against Arma, even though it already had an unsatisfied money judgment against the debtor and did not repossess the collateral.

Kansas courts would likely reach the same result. The Kansas Court of Appeals in *Farmers State Bank v. FFP Operating Partners, L.P.*, discussed above,<sup>115</sup> found FFP liable to a secured party for conversion of collateral. FFP argued it was entitled to the collateral free of the prior security interest because the debtor had abandoned it, cutting off the secured party's rights. The court disagreed, stating "even if we were to assume [the debtor] abandoned the inventory, that fact is no defense to FFP's blatant violation of the [secured party's] security interest."<sup>116</sup> Secured parties may thus repossess or sue for conversion under § 84-9-315 when collateral is abandoned. If their security interest is not perfected, however, such secured parties may be subordinate to a taker or transferee of the abandoned collateral that qualifies as a buyer not in the ordinary course under Kan. Stat. Ann. § 84-9-317(b).

#### 5. Production Buyers' Rights Under Non-UCC Kansas Law

Turning briefly to non-UCC real property law, subsequent buyers of property generally take subject to prior-recorded mortgages.<sup>117</sup> Real property encumbered by a mortgage remains alienable by the debtor. A grantee of encumbered property takes subject to recorded mortgages. Unrecorded

mortgages are not enforceable against subsequent buyers of the property who buy without knowledge of the mortgage.<sup>118</sup> Kansas real property law, like Article 9, appears to permit a mortgagee to retake possession of abandoned collateral over claims of transferees.<sup>119</sup>

If the collateral is a type of leasehold interest, the lender's rights may not be enforceable against the lease, the debtor, or subsequent lessees if the lease terminates. A typical oil and gas lease provides for a definite, or primary, term of years followed by a secondary term that continues as long as oil or gas is produced from the premises in commercial quantities.<sup>120</sup> Courts have held that with expiration of the lease, the mortgage expires, too. In *Macquarie Bank v. Knickel*, a case before the United States District Court for the District of North Dakota, the plaintiff loaned money to defendants to develop oil and gas leases.<sup>121</sup> The plaintiff took and perfected a mortgage and security interest in collateral that included several oil and gas leases. The defendants defaulted and the plaintiff foreclosed on the leases, but the primary terms of several leases had already expired. The plaintiff claimed the defendants converted its liens in the leases by allowing them to expire without renewing them. The court denied the claim, holding that plaintiff's liens in the leases expired when the leases did and the security agreement did not prohibit defendants from letting the leases expire.<sup>122</sup>

The holding in *Knickel* generally aligns with Kansas real property law. In the context of statutory liens, when the issue has arisen, the rights of a lien claimant "can rise no higher" than those of the debtor.<sup>123</sup> When the debtor's only interest in real property is a leasehold interest, and the debtor abandons its interest or it otherwise terminates, the lien claimant's lien in the debtor's interest "become[s] a nullity."<sup>124</sup> A lender on an oil and gas lease may be able to protect itself by drafting the mortgage or security agreement to require the debtor to renew or extend the lease rather than let it expire. If the collateral lease expires, the lender may at least have a claim for conversion or breach of the mortgage or security agreement.

### B. Priority Against Other Competing Consensual Liens

#### 1. Priorities Under Article 9: Kan. Stat. Ann. §§ 84-9-317 and 9-322

The general rules of priority among competing liens under Article 9 are as follows. A security interest is subordinate to prior perfected security interests<sup>125</sup> as well as persons that become lien creditors before the security interest is perfected.<sup>126</sup> Perfected security interests in the same collateral rank according to priority in time of perfection.<sup>127</sup> As between unperfected security interests in the same collateral, the first security interest to attach or become effective has priority. A purchase-money security interest in goods (other than inventory) has priority over a conflicting security interest in the same goods.<sup>128</sup> Security agreements commonly provide that



the collateral secures future advances to the debtor.<sup>129</sup> Generally the time a future advance is made plays no role in determining priorities among conflicting security interests.<sup>130</sup> For purposes of determining priority, an advance made under a future-advances clause is considered perfected when the underlying security interest was perfected.

A security interest is subordinate to the rights of a person that becomes a lien creditor before the security interest is perfected.<sup>131</sup> A *lien creditor* means (1) a creditor that has acquired a lien by attachment, levy, or the like; (2) an assignee for benefit of creditors from the time of assignment; (3) a trustee in bankruptcy from the date of filing of the petition; or (4) a receiver in equity from the time of appointment.<sup>132</sup> The most common types of lien creditors are execution creditors and trustees in bankruptcy. The Bankruptcy Code, 11 U.S.C. § 544(a)(1), grants trustees in bankruptcy the status of a hypothetical lien creditor as of the date of the bankruptcy petition. The trustee can avoid liens that were unperfected on that date as a hypothetical lien creditor could, and thus preserve the property for the bankruptcy estate. To prevail on an avoidance claim, “the trustee must show that the competing creditor has a valid lien in the subject property and that the lien was not properly perfected as of the commencement of the bankruptcy case. If the creditor’s lien never attaches, there is no lien for the trustee to avoid...”<sup>133</sup> Article 9 contains special rules pertaining to lien creditors’ priority as to competing security interests that are beyond the scope of this discussion.<sup>134</sup>

Competing rights to fixtures are governed by special rules because of their unique quality of transcending real and personal property. A security interest in fixtures is generally subordinate to a conflicting interest of an encumbrancer or owner of the related real property to which the fixtures are annexed (unless the owner of the real property is the debtor, in which case the security interest would necessarily obtain priority).<sup>135</sup> Under Kan. Stat. Ann. § 84-9-334(f)(2), however, the secured party has priority over the owner or encumbrancer if the debtor has a right to remove the fixtures as against the owner or encumbrancer. In the oil and gas context, Kansas law permits lessees to remove equipment and casing anytime during the lease term and for a reasonable time after termination.<sup>136</sup> Security interests in a lessee’s equipment and casing therefore should claim priority over the rights of the landowner and mortgagees. This is not true if the secured property is deemed to be personal property. When the status of the secured property is unclear, a lender should consider obtaining a subordination agreement from the landowner or competing encumbrancer.

## 2. Priorities Under Kansas Real Property Law

The priority of competing mortgages is generally based on order of recording.<sup>137</sup> Purchase-money mortgages, however, take priority over earlier-recorded ones if they are recorded without “unnecessary delay.”<sup>138</sup> Mortgages in oil and gas leasehold interests often secure future advances.<sup>139</sup> The mortgage

has priority as of the time of its recording as to all advances made thereunder until the mortgage is released of record, except for advances made that exceed the maximum amount stated in the mortgage.<sup>140</sup>

## 3. Competing Priorities of Nonpossessory Statutory Liens

Priority issues often arise when oil and gas leases, wells, equipment, and materials become subject to both consensual liens and statutory oil and gas liens. Chapter 55 of the Kansas Statutes provides for nonpossessory liens in oil and gas property in favor of oilfield contractors, subcontractors, and transporters to secure payment for goods and services. These so-called oil and gas mechanics’ liens and their priority over other nonpossessory statutory liens and security interests are not governed by Article 9.<sup>141</sup>

Kan. Stat. Ann. § 55-207 provides a lien in oil and gas leases, wells, pipelines, equipment, and materials in favor of any person that, under an express or implied contract with the owner of an oil and gas leasehold interest or pipeline, performs labor or furnishes materials in the development, operation, or maintenance and repair of the leasehold or pipeline. Kan. Stat. Ann. § 55-208 provides a lien in favor of any person that furnishes machinery or supplies or performs labor as a subcontractor for an oil and gas leasehold or pipeline owner. Kan. Stat. Ann. § 55-213 provides a lien in favor of any person that transports or hauls oilfield equipment, defined in § 55-212, under an express contract with the owner or operator of an oil and gas lease, pipeline, or oilfield equipment.

Kan. Stat. Ann. § 55-207 controls the priority of §§ 55-207, -208, and -213 liens. The liens “shall be preferred to all other liens, or encumbrances which may attach to or upon such leasehold . . . and upon any oil pipeline, or gas pipeline, or such oil and gas wells . . . subsequent to the commencement of or the furnishing or putting up of any such machinery or supplies.” Kansas courts hold that these liens have priority over security interests, mortgages, and other nonpossessory statutory liens that attach after the lienor first performed labor and furnished materials, but are subordinate to such interests that attach before that time.<sup>142</sup> One court has held that a § 55-207 lien is subordinate to a subsequent purchase-money security interest.<sup>143</sup>

## V. Enforcement of Liens in Oil and Gas Property

Consensual liens are generally enforceable against the collateral and the debtor if and when the debtor defaults on the underlying obligation. The security agreement or mortgage document defines when default occurs and the agreements and liens may be enforced. The debtor’s failure to pay the debt as required is usually an event of default, but noneconomic acts or omissions of the debtor may also constitute events of default. Agreements commonly provide the debtor an opportunity to cure the default, such as by paying late subject to a fee. It is possible for a secured party to waive its rights to en-

force the debt and related lien by failing to timely act in response to a default. The terms of the security agreement or mortgage may help avoid this pitfall by requiring any waiver of rights to be in writing. The remainder of this section discusses a secured party's rights and duties with respect to enforcing its liens upon default.

### A. Enforcing the Article 9 Security Interest

In many oil and gas financing transactions, the collateral consists of both real and personal property. The typical oil and gas mortgage encumbers an oil and gas leasehold interest, which is real property, as well as the proceeds of production (or the runs) and wells and equipment, which are personal property. In mixed-collateral situations, secured parties may proceed either under Part 6 of Article 9 as to the collateral that is personal property (without prejudicing its rights to proceed separately against the real property collateral as well), or proceed completely outside the provisions of Article 9 as to both the personal and real property under real property law.<sup>144</sup> Article 9 likewise permits secured lenders with rights in fixtures to proceed against the fixtures under either Article 9 or applicable real property law.<sup>145</sup>

There are many avenues for enforcement following a default under Article 9 and the remedies are cumulative, not exclusive.<sup>146</sup> A secured party may reduce its claim for default to judgment, foreclose, or otherwise enforce the security interest by any available judicial procedure.<sup>147</sup> If the secured party reduces its claim to judgment, it may execute on the collateral and sell it under judicial procedure. The secured party may purchase the collateral at the sale.<sup>148</sup> The secured party may instead repossess the collateral or render it unusable either under judicial process or, if it does not breach the peace, without judicial process.<sup>149</sup> If permitted by the security agreement, the secured party may require the debtor to assemble the collateral and make it available to the secured party at a designated place.<sup>150</sup>

The secured party may then sell, lease, license, or otherwise dispose of collateral or take it in full or partial satisfaction of the debtor's obligation if the debtor and other interested parties consent.<sup>151</sup> If the secured party disposes of the collateral, it must do so in a commercially reasonable manner.<sup>152</sup> If it is commercially reasonable, the secured party may dispose of the collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place



on any terms.<sup>153</sup> The secured party may purchase the collateral in satisfaction of its claim at a public disposition, or privately if the collateral is of a kind customarily sold on a recognized market or subject to distributed standard price quotations.<sup>154</sup>

A secured party holding a security interest in fixtures that has priority over all owners and encumbrances of the real property may remove the collateral from the real property after default.<sup>155</sup> The secured party will be liable to any such owner or encumbrancer only for the cost of repair of physical injury caused by removal, but not for diminution in the real property's value as a result of removal.<sup>156</sup>

Article 9 requires a secured party to proceed in a commercially reasonable manner in collecting or enforcing an obligation.<sup>157</sup> The commercial reasonableness requirement exists to protect the debtor from a deficiency judgment or the squandering of a surplus because of the secured party's actions or omissions.<sup>158</sup> The leading case in Kansas on commercial reasonableness is *Westgate State Bank v. Clark*.<sup>159</sup> *Clark* adopts the so-called totality of the circumstances test for determining commercial reasonableness. In it, the Kansas Supreme Court set forth the nonexclusive factors that determine the reasonableness of a disposition: (1) the duty to clean up, fix up, and paint up the collateral; (2) whether disposition was made public or private; (3) whether the collateral was disposed of wholesale or retail; (4) whether the collateral was disposed of by unit or in parcels; (5) the secured party's duty to advertise the sale; (6) the length of time the collateral is held prior to sale; (7) the creditor's duty to give notice of the sale to the debtor and competing secured parties; (8) the actual price received at the sale; and (9) other factors such as the number of bids received and the method employed to solicit bids.<sup>160</sup>

The fact a better price could have been obtained at a sale at a different time or place or by a different method is not sufficient alone to establish that the sale was not commercially reasonable.<sup>161</sup> There is a safe harbor for sales made in the usual manner on a recognized market, at the price current in any recognized market at the time of disposition, or otherwise in conformity with reasonable commercial practices among dealers in the collateral.<sup>162</sup> A sale is also per se commercially reasonable if a court approves it.

As the Tenth Circuit case *Liberty National Bank & Trust Company v. Acme Tool Division of Rucker Company*<sup>163</sup> illustrates, it is important to conduct collateral sales roughly ac-

according to industry standards. The secured party in that case had been advised of the industry's standard method for selling the drilling rig securing the loan. The standard was to clean and paint it, move it to a convenient location, schedule an auction, notify interested persons, and advertise the auction in trade journals and newspapers. Instead the secured party sold the uncleaned, unpainted drilling rig on the drilling site, with an untrained and inexperienced auctioneer, and without advertising the sale. To make matters worse, the sale took place during a blizzard. The court concluded the secured party failed to take reasonable steps to maximize the price for the rig at the public sale and violated the rights of a competing secured party.<sup>164</sup>

There are consequences for selling collateral in an unreasonable manner. If a court determines that a secured party is not proceeding in a commercially reasonable manner, it may restrain disposition of the collateral and award the debtor damages against the secured party.<sup>165</sup> A competing secured party may also claim damages, as in *Acme Tool Division of Rucker Company*.<sup>166</sup> Courts may also award the debtor and competing secured parties a civil penalty of \$500 per violation of Article 9.<sup>167</sup> A secured party may recover a deficiency judgment against the debtor for the amount by which the debt exceeds the proceeds of the collateral, even if the sale of the collateral was not commercially reasonable.<sup>168</sup> However, in any action to recover the deficiency judgment there is a rebuttable presumption that the value of the collateral was equal to the unpaid balance of the debt. The secured party has the burden of rebutting the presumption. The debtor may set off its damages from an unreasonable sale against the amount owed to the secured party.

## B. Enforcing Non-UCC Liens in Kansas

Under Kan. Stat. Ann. § 55-210, liens in oil and gas leasehold interests are enforced in the same manner as mortgages in real property.<sup>169</sup> In Kansas, a mortgagee brings a foreclosure action to enforce a mortgage in oil and gas leasehold interests and the underlying debt.<sup>170</sup> Unlike the enforcement of an Article 9 security interest, a mortgage foreclosure is an equitable action.<sup>171</sup> The mortgagor seeking foreclosure must maintain "clean hands" throughout the process to be entitled to equity.<sup>172</sup> A lender therefore must proceed reasonably in collecting or enforcing an obligation under both Article 9 and Kansas real property law.

The mortgagor is a necessary party to a mortgage foreclosure action. Mortgagees should also name any other person who claims an interest in the subject leasehold interest, including junior mortgagees, lien creditors, and statutory lienholders. The foreclosure proceeding merges all junior encumbrances in the property joined in the lawsuit and extinguishes them.<sup>173</sup> Although junior encumbrancers are not necessary parties for jurisdiction, any junior encumbrancer not joined in the action may assert its rights to the collateral following a sheriff's

sale.<sup>174</sup> Junior encumbrancers must answer or appear in the proceedings to claim a share of any excess sale proceeds beyond the amount of the mortgage being foreclosed.<sup>175</sup>

When a lease is producing income at the time of default, the mortgagee generally wants to take possession of the production and the runs before reducing its claim to judgment in a foreclosure action. For this reason, oil and gas leasehold mortgages often assign the rents and runs to the mortgagee upon an event of default. The runs are applied against the debt. Mortgages may alternatively authorize the mortgagee to petition a court to appoint a receiver to collect rents and runs and apply them against the debt.<sup>176</sup>

The district court determines the amount of the debt and the priority of competing liens in the leasehold collateral in a journal entry of judgment. Because judgment may be entered only for past due amounts, mortgages typically contain an acceleration clause that causes the entire debt secured by the mortgage to become immediately due on default. If the debtor fails to pay the judgment, the mortgagee may ask the court for an order of sale directing the sheriff to sell the lease for cash.<sup>177</sup> Oil and gas leases are sold as real property under the execution provisions of Article 24 of the Kansas Code of Civil Procedure.<sup>178</sup> The mortgagee must advertise the sale and publish notice of it once a week for three consecutive weeks in the official newspaper of the county where the lease is located.<sup>179</sup> The mortgagee may credit bid the amount of its judgment at the sheriff's sale. As under Article 9, the mortgagee may seek a deficiency judgment against the mortgagor personally for the amount by which the judgment exceeds the sale proceeds.<sup>180</sup> The court has no discretion in entering a deficiency judgment, and it is a mathematical equation.<sup>181</sup>

After the sheriff's sale, the sheriff returns to the court an order of sale indicating the purchaser of the collateral and the amount of the purchase price. The mortgagee must then ask the court to confirm the sale. The court may deny confirmation of the sale if it finds the bid to be substantially inadequate.<sup>182</sup> In determining whether the bid was substantially inadequate, the court does not consider the impact of the foreclosure proceeding itself on the price nor deduct holding costs.<sup>183</sup> The court may consider local, long-term economic conditions; the type of property involved; its unique qualities, if any; its intrinsic worth; and other characteristics affecting the collateral's value.<sup>184</sup> If the court confirms the sale, the sheriff must execute a sheriff's deed conveying the property to the purchaser.<sup>185</sup> The sheriff's deed should describe the lease and the real property it covers. The purchaser should record the sheriff's deed in the office of the register of deeds for the county where the lease is located. The debtor under an oil and gas leasehold lien has no right of redemption.<sup>186</sup>

## VI. Conclusion

The stakes are high in many oil and gas secured transactions, the collateral can have different property characteristics,



and the law is complex and often incomplete. Practitioners should begin their examination of any transaction by determining the proper classification for each type of collateral. If the proper classification is unclear, the practitioner should perfect in all the ways that might be appropriate. Counsel generally drafts a single mortgage, security agreement, and financing statement that describes all the collateral, including leasehold interests, extracted oil and gas, wells and equipment, and all other real and personal property necessary to the operation of the producing unit. The omnibus document is recorded in the office of the register of deeds as a mortgage and a fixture filing and filed in the Secretary of State's central filing office as a financing statement. In the enforcement of liens, practitioners should consider industry standards to determine what method of disposition is commercially reasonable. ■

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*Coffelt*, 395 B.R. 133, 139–40 (Bankr. D. Kan. 2008); *Garnett State Sav. Bank v. Tush*, 657 P.2d 508, 514 (Kan. 1983).

13. *Tush*, 657 P.2d at 514.
14. See *Waters*, 854 P.2d at 314.
15. K.S.A. 84-9-109.
16. *Waters*, 854 P.2d at 314.
17. K.S.A. 58-2221.
18. K.S.A. 58-2222; see generally *Miso Indus., Inc. v. Bd. of Cnty. Comm'rs of the Cnty. of Sedgwick*, 685 P.2d 866, 869–70 (Kan. 1984).
19. K.S.A. 58-2223; see also *In re Coffelt*, 395 B.R. at 140.
20. K.S.A. 84-9-301(4).
21. See K.S.A. 84-9-301(3)(C). This is a change from former Article 9. *Id.* off. cmt.7.
22. See generally *id.* off. cmt. #7.
23. K.S.A. 84-9-102(44).
24. K.S.A. 84-9-102(33).
25. K.S.A. 84-9-102(a)(41).
26. K.S.A. 84-9-102(a)(44).
27. K.S.A. 84-9-102(a)(2).
28. K.S.A. 84-9-102(a)(44).
29. See 2 BARKLEY CLARK, ET AL., THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 13.03[2] (3d ed. 2013).
30. K.S.A. 84-9-102(a)(6).
31. K.S.A. 84-9-102 off. cmt.4.c.
32. K.S.A. 84-9-301(4).
33. K.S.A. 84-9-501(a)(1)(A).
34. K.S.A. 84-9-502(a)–(b).
35. K.S.A. 84-9-502(c).
36. K.S.A. 84-9-519(d). In Kansas, registers of deeds have no duty to furnish a numerical tract index unless the board of county commissioners “deems it necessary.” K.S.A. 19-1209. Nearly all registers of deeds offices maintain numerical tract indexes.
37. See *Drach v. Ely*, 703 P.2d 746, 750 (Kan. 1985).
38. *Muslow v. Gerber Energy Corp.*, 697 P.2d 1269, 1272–73 (Kan. 1985).
39. *Burden v. Gypsy Oil Corp.*, 40 P.2d 463, Syl. ¶ 2 (Kan. 1935).
40. 521 P.2d 254, Syl. ¶ 3 (Kan. 1974).
41. K.S.A. 58-2221.
42. See, e.g., *Cruse v. Marston*, 148 P.2d 1004, 1005–06 (Colo. 1944).
43. See 1 DAVID E. PIERCE, KANSAS OIL AND GAS HANDBOOK § 4.09 (Kan. Bar Ass'n. 1986).
44. 8 PATRICK H. MARTIN AND BRUCE KRAMER, WILLIAMS & MEYERS, OIL AND GAS LAW 728 (LexisNexis Matthew Bender 2016).
45. *Campbell v. Nako Corp.*, 402 P.2d 771, Syl. ¶ 2 (Kan. 1965).
46. MARTIN & KRAMER, *supra* note 44, at 691, 824.1.
47. *Id.* at 649.
48. CLARK, *supra* note 29, ¶ 13.02[3] (citing *Messersmith v. Smith*, 60 N.W.2d 276 (N.D. 1953); *Bolack v. Hedges*, 240 P.2d 844 (N.M. 1952); *Elliott v. Sioux Oil Co.*, 191 F. Supp. 847 (D. Wyo. 1960); *Standard Oil Co. v. Marshall*, 265 F.2d 46 (5th Cir. 1959); *Stone v. Wright*, 75 F.2d 457 (10th Cir. 1935); *Beshara v. Goldberg*, 34 Cal. Rptr. 501 (Cal. Ct. App. 1963)).
49. *Nat'l Bank of Tulsa v. Warren*, 279 P.2d 262, Syl. (Kan. 1955).
50. *Id.* at 264.
51. See *Muslow*, 697 P.2d at 1274 (holding that overriding royalty interests are not subject to partition because “the nature of an overriding royalty interest is such that only when oil and gas are reduced to possession does the interest attach. The overriding royalty interest does not create a cotenancy in the leasehold or a possessory interest.”); accord *Meeker v. Ambassador Oil Co.*, 308 F.2d 875, 882–83 (10th Cir. 1962) (Okla.), *rev'd* 375 U.S. 160, 84 S. Ct. 273, 11 L. Ed. 2d 261 (1963).
52. See generally *Wellsville Bank v. Nicolay*, 638 P.2d 975 (Kan. Ct. App. 1982), which holds that a partner's assignment of his rights to pay-

1. See *Woodward v. Wright*, 266 F.2d 108, 115 (10th Cir. 1959) (“We know that oil and gas financing is a strange world of its own.”).
2. See K.S.A. 55-207, -208 & -213 (providing statutory nonpossessory liens for services and materials furnished for the benefit of oil and gas property). For a thorough treatment of Kansas oil and gas mechanics liens, see generally David E. Pierce, *Kansas Oil And Gas Lien Law*, J. KAN. BAR ASS'N., Aug. 1987, Issue 7, at 8 (1987) (discussing oil and gas statutory liens).
3. Black's Law Dictionary 1475 (9th ed.).
4. *Id.* at 1006.
5. *Id.*
6. See *Kan. City Heartland Constr. Co. v. Maggie Jones Southport Café, Inc.*, 824 P.2d 926, Syl. ¶ 3 (Kan. 1992).
7. K.S.A. 84-9-109; *Kinsley State Bank v. Waters*, 854 P.2d 311, 314 (Kan. Ct. App. 1993).
8. See *Waters*, 854 P.2d at 314.
9. K.S.A. 84-9-308 off. cmt. #2.
10. K.S.A. 84-9-203(a).
11. K.S.A. 84-9-203(b).
12. See K.S.A. 33-106 (requiring mortgages to be in writing and signed by the mortgagor); *Redmond v. M&I Marshall & Ilsley Bank (In re*

ment and benefits under the partnership's contract to assign an oil and gas lease created a security interest under Article 9 which must be perfected, if at all, by filing a financing statement. Nicolay should caution any lender which takes a lien in a right to receive payment from production of oil or gas such as, arguably, an overriding royalty interest, production payment, or net profits interest.

53. See K.S.A. 84-9-607 off. cmt. #2 (“[T]his section allows the assignee to liquidate collateral by collecting whatever may become due on the collateral, whether or not the method of collection contemplated by the security arrangement before default was direct . . . or indirect.”).

54. *Atchison, Topeka & Santa Fe R.R. Co. v. Morgan*, 21 P. 809, 811 (Kan. 1889).

55. K.S.A. 84-9-102(a)(41).

56. K.S.A. 84-9-109(a)(1).

57. *In re Thomas*, 362 B.R. 478, 485 (B.A.P. 10th Cir. 2007).

58. *City of Wichita v. Denton*, 294 P.3d 207, 217 (Kan. 2013).

59. *In re Sand & Sage Farm & Ranch, Inc.*, 266 B.R. 507, 511 (Bankr. D. Kan. 2001).

60. 21 P. 809 (Kan. 1889).

61. *Id.* at 812–13.

62. *Id.* at 813.

63. *Pratt v. Gerstner*, 360 P.2d 1101, 1104 (Kan. 1961) (quoting 3 SUMMERS, THE LAW OF OIL AND GAS § 526, p. #453 (perm. ed.)); see also *Arney v. Hoffman*, No. 83,695, 2000 Kan. App. unpub. LEXIS 1040, at \*2–3 (Kan. Ct. App. Mar. 3, 2000) (citing 3 SUMMERS OIL AND GAS § 526 (1988)). Though these cases clearly apply the majority rule that well casings are trade fixtures, they are not precedential on this point. This is the rule in Oklahoma, as well. *Gutierrez v. Davis*, 618 F.2d 700, 702 (10th Cir. 1980) (Okla.).

64. K.S.A. 84-9-310(a) (requiring filing a financing statement for perfection), -501(a)(1)(B) (designating the register of deeds office of the county where the fixture is located as the place for filing fixture filing), -502(b) (stating requirements for fixture filing) & -502(c) (stating requirements for a mortgage to be effective as a fixture filing); see also *supra* text accompanying notes 32–34.

65. K.S.A. 84-9-310(a) (requiring filing a financing statement for perfection) & -501(a)(2) (designating the Secretary of State's office as the place for filing the financing statement).

66. K.S.A. 84-9-502(a).

67. K.S.A. 84-9-301(1).

68. K.S.A. 84-9-307(b).

69. K.S.A. 84-9-501(a)(2).

70. See K.S.A. 84-09-301(3)(C).

71. K.S.A. 84-9-502(c).

72. K.S.A. 84-9-310(a), -501(a)(1)(B).

73. K.S.A. 84-9-310(a), -501(a)(2).

74. K.S.A. 84-9-311(a)(2).

75. K.S.A. 84-9-303(b).

76. K.S.A. 84-9-303(c).

77. K.S.A. 8-135(c)(6) (requiring taking possession of the certificate of title, completing an application for a mortgage title prescribed by the Kansas Department of Revenue, and delivering both the title and mortgage title application, along with a fee, to the Department); see also K.S.A. 8-135(c)(5) (stating requirements for perfection of a purchase-money security interest in a vehicle covered by a certificate of title).

78. See *In re Dawley*, 30 B.R. 477, 478–79 (Bankr. W.D. Pa. 1983) (affirming district court finding that a drilling rig “lost its identity as separate piece of equipment when built and incorporated into the Mack International Truck.”).

79. See K.S.A. 84-9-335(d).

80. K.S.A. 84-9-102(a)(81).

81. K.S.A. 84-9-501(b).

82. K.S.A. 84-9-102(a)(81).

83. K.S.A. 84-9-310(a), -501(a)(1)(B).

84. K.S.A. 84-9-401(a)–(b).

85. K.S.A. 84-9-201(a).

86. K.S.A. 84-9-315(a)(1).

87. K.S.A. 85-9-315(a)(2).

88. K.S.A. 85-9-315 off. cmt. #2.

89. *Id.*

90. 935 P.2d 233 (Kan. Ct. App. 1997).

91. *Id.* at Syl. ¶ 3.

92. *Id.* at 235–36.

93. K.S.A. 84-9-317(b).

94. K.S.A. 84-1-204.

95. K.S.A. 84-1-202(b).

96. *Broadway Nat'l Bank v. G&L Athletic Suppliers, Inc.*, 691 P.2d 400, Syl. ¶ 2 (Kan. Ct. App. 1984).

97. See K.S.A. 84-9-308, off. cmt. #2.

98. See K.S.A. 84-9-515(c) (stating financing statements lapse after five years).

99. K.S.A. 84-9-515(a), (c).

100. K.S.A. 84-9-515(e).

101. K.S.A. 84-9-515(g).

102. K.S.A. 58-2333i(b). Mortgages filed prior to January 1, 1965, are generally deemed ineffective by K.S.A. §§ 58-2332 – -2333i.

103. K.S.A. 84-1-201(b)(9).

104. K.S.A. 84-9-102(a)(32).

105. K.S.A. 84-9-315(a)(2).

106. K.S.A. 84-9-339a.

107. K.S.A. 84-9-339a(p)(3).

108. K.S.A. 84-9-339a(a).

109. *Arrow Oil & Gas, Inc. v. J. Aron & Co. (In re SemCrude, L.P.)*, 864 F.3d 280, 291–93 (3d Cir. 2017).

110. *Id.* The court noted that while the collateral in this case was produced crude oil, it was goods rather than as-extracted collateral because SemCrude did not have a pre-extraction interest in the crude oil. The distinction is significant because a security interest in as-extracted collateral is perfected under the law of the wellhead's location, here Kansas, rather than the debtor's location, which was Delaware.

111. K.S.A. 84-9-339a(p)(3).

112. In Kansas, a lessee under an oil and gas lease may remove casing, derricks, engines, and other machinery placed by the lessee on the premises any time during the existence of the lease. If the lessee does not remove any such property within a reasonable time following termination, the property is presumed abandoned and becomes the property of the landowner. *Pratt v. Gerstner*, 360 P.2d 1101, 1104 (Kan. 1961).

113. No. 85 Civ. 5399 (BN), 1991 U.S. Dist. LEXIS 3614 (S.D.N.Y. Mar. 25, 1991).

114. *Id.* at \*22 (citing U.C.C. § 9-306(2); *Taylor Rental Corp. v. J.I. Case Co.*, 749 F.2d 1526, 1529 (11th Cir. 1985); 69 Am. Jur. 2d § 459, p.312)).

115. 935 P.2d 233 (Kan. Ct. App. 1997); see *supra* text accompanying notes 89–92.

116. *Id.* at 236.

117. See K.S.A. 58-2222.

118. K.S.A. 58-2223.

119. See *Sallee v. King*, 277 P. 49, 50 (Kan. 1929) (“The taking of possession is a method of payment and is one of the remedies afforded mortgagees to obtain satisfaction of their liens.”).

120. See *Pray v. Premier Petroleum, Inc.*, #662 P.2d 255, 257 (Kan. 1983) (discussing the habendum clause of oil and gas leases).

121. 723 F. Supp. 2d 1161 (D.N.D. 2010).

122. *Id.* at 1200–01.

123. *Kan. City Heartland Constr. Co. v. Maggie Jones Southport Café, Inc.*, 824 P.2d 926, Syl. ¶ 3 (Kan. 1992).

124. *Manhattan Mall Co. v. Shult*, 864 P.2d 1136, 1141 (Kan. 1993).

125. K.S.A. 84-9-317(a)(1), -322(a).

126. K.S.A. 84-9-317(a)(2)(A).  
 127. K.S.A. 84-9-322(a)(1).  
 128. K.S.A. 84-9-324(a).  
 129. See K.S.A. 84-9-204(a).  
 130. K.S.A. 84-9-323 off. cmt. #3.  
 131. K.S.A. 84-9-317(a)(2)(A).  
 132. K.S.A. 84-9-102(a)(52).  
 133. *Morris v. Ark Valley Credit Union (In re Gracy)*, Case No. 13-11917, 2014 Bankr. LEXIS 4559, at \*5-6 (Bankr. D. Kan. Oct. 30, 2014), vacated and remanded by 536 B.R. 887 (D. Kan. 2015).  
 134. See K.S.A. 84-9-317 off. cmts. #4-5 (concerning filed but unattached security interests vs. lien creditor and security interest of consignee or receivables buyer v. lien creditor, respectively).  
 135. K.S.A. 84-9-334(c).  
 136. *Pratt v. Gerstner*, 360 P.2d 1101, 1103-04 (Kan. 1961) see *supra* note 112.  
 137. See generally *Middlekauff v. Bell*, 207 P. 184 (Kan. 1922); K.S.A. 58-2222 & -2223.  
 138. *Kuehn v. Am. Nat'l Bank*, 232 P. 1060, 1061 (Kan. 1925).  
 139. K.S.A. 58-2336.  
 140. *Id.*  
 141. *Nat'l Supp. Co., Div. of Armco, Inc. v. Case Oil & Gas, Inc.*, 772 P.2d 1255, 1256 (Kan. Ct. App. 1989).  
 142. See *Moyer v. Hezlep*, 257 P. 229 (Kan. 1927); *R.W. Pickering Lumber Co. v. Eisenhour*, 264 P. 144 (Kan. 1928).  
 143. *Nat'l Supp. Co., Div. of Armco, Inc. v. Case Oil & Gas, Inc.*, 772 P.2d 1255, 1256 (Kan. Ct. App. 1989).  
 144. K.S.A. 84-9-604(a); see also *Northern Tr. Co. v. Buckeye Petroleum Co.*, 389 N.W.2d 616, 620 (N.D. 1986) (holding that a secured party that elected to proceed under Article 9 only as to the personal property collateral did so properly and did not waive its rights under North Dakota real property law to proceed against the oil and gas leasehold collateral which was characterized as real property).  
 145. K.S.A. 84-9-604(b); *Morris v. Dickinson Cnty. Bank (In re Moore)*, Case No. 09-11051, 2011 Bankr. LEXIS 1069, at \*17-18 (Bankr. D. Kan. Mar. 23, 2011).  
 146. K.S.A. 84-9-601(c).  
 147. K.S.A. 84-9-601(a)(1).  
 148. K.S.A. 84-9-601(f).  
 149. K.S.A. 84-9-609(a)-(b).  
 150. K.S.A. 84-9-609(c).  
 151. K.S.A. 84-9-620(a)-(c).  
 152. K.S.A. 84-9-610(a)-(b).  
 153. K.S.A. 84-9-610(b).  
 154. K.S.A. 84-9-610(c).  
 155. K.S.A. 84-9-604(c).  
 156. K.S.A. 84-9-604(d).  
 157. K.S.A. 84-9-607(c).  
 158. *Gillenwater v. Mid-Am. Bank & Tr. Co.*, 870 P.2d 700, 703 (Kan. Ct. App. 1994) (citing *Fed. Dep. Ins. v. Fort Worth Aviation*, 806 F.2d 575, 577 (5th Cir. 1986)).  
 159. 642 P.2d 961 (Kan. 1982).  
 160. *Id.* at 970-71.  
 161. K.S.A. 84-9-627(a).  
 162. K.S.A. 84-9-627(b)(1)-(3).  
 163. 540 F.2d 1375 (10th Cir. 1976).  
 164. *Id.* at 1381-82.  
 165. K.S.A. 84-9-625(a)-(b).  
 166. K.S.A. 84-9-625(c)(1).  
 167. K.S.A. 84-9-625(e).  
 168. *Clark*, 642 P.2d at 969.  
 169. *Accord Ingram v. Ingram*, 521 P.2d 254, 259 (Kan. 1974).  
 170. For a thorough survey of the procedure and substance of mortgage foreclosure in Kansas, see KANSAS REAL ESTATE LAW HANDBOOK, Mortgages and Conventional Real Estate Lending §§ 6.4-6.4.3 (Kan. Bar Ass'n).  
 171. *Bank of Whitewater v. Decker Inv., Inc.* 710 P.2d 1258, 1263 (Kan. 1985).  
 172. *Fuqua v. Hanson*, 567 P.2d 862, 866-67 (Kan. 1977).  
 173. *Fidelity Bank v. King*, 109 P.3d 180, Syl. ¶ 1 (Kan. Ct. App. 2005).  
 174. *Stacey v. Tucker*, 254 P. 339, Syl. ¶ 1 (Kan. 1927).  
 175. *King*, 109 P.3d 180, Syl. ¶ 2.  
 176. See K.S.A. 58-2343; see, e.g., *Mid-Continent Supp. Co. v. Hauser*, 269 P.2d 453 (Kan. 1954) (discussing the appointment of a receiver in an oil and gas lease mortgage foreclosure proceeding).  
 177. See K.S.A. 60-2410.  
 178. K.S.A. 60-2401(d).  
 179. K.S.A. 60-2410(a).  
 180. See *Fed. Land Bank of Wichita v. Cummings*, 735 P.2d 1110, 1112 (Kan. 1987) ("Deficiency judgments are contemplated and permitted by Kansas law.")  
 181. *Olathe Bank v. Mann*, 845 P.2d 639, Syl. ¶ 1 (Kan. 1993).  
 182. K.S.A. 60-2415(a).  
 183. *Mann*, 845 P.2d at Syl. ¶ 3.  
 184. *Id.* at Syl. ¶ 2.  
 185. K.S.A. 60-2410(e).  
 186. K.S.A. 55-210.

