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Use of the Model Form Operating Agreement for the Creation and Enforcement of a Security Interest

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USE OF THE MODEL FORM OPERATING AGREEMENT
FOR THE CREATION AND ENFORCEMENT
OF A SECURITY INTEREST

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I. INTRODUCTION

The exploration for, and production of, oil and gas can be an expensive and high risk venture. Prior to drilling, many thousands of dollars are spent for lease acquisition, title opinions, and other expenses associated with obtaining a clear right to develop the minerals under a particular tract of land. After title acquisition, hundreds of thousands of dollars may be spent to drill and complete the well. Due to the great expenses and risk involved, several parties often contract to share the expenses and revenues of the drilling venture.¹ This business relationship between the participants in an oil and gas drilling venture is usually governed by a lengthy contractual instrument known in the trade as the Model Form Operating Agreement (Model Agreement).²

Under the usual framework of the Model Agreement, one participating party (who usually controls the majority of the leased interest(s)) is designated the “operator”³ of the well. The duties of

1. The author assumes that the drilling was an economic success.

2. See A.A.P.L. Form 610-1982 Model Form Operating Agreement. Operating agreements are necessary when the tract or leasehold is concurrently owned. 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 503.2 (1985). In such a case the concurrent owners enter into an operating agreement that specifies the rights and liabilities of the parties. *Id.*

3. An “operator” has been defined as “[a] person, natural or artificial (*e.g.*, corporate) engaged in the business of drilling wells for oil and gas.” 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 595 (1984). For purposes of unit agreements, which are agreements to operate a number of wells over a particular oil and gas reservoir, an operator has been defined as:

[A]ny owner of the right, in whole or in part, to search for and produce unitized substances within the [contract area], whether such right be derived from the ownership of the entire title free of lease, or by oil, gas and mineral leases or by any other species of agreement conferring such right.

the operator include contracting for the work to be done on the well, negotiating the purchase of the runs⁴ for the well, and having the primary responsibility to pay those parties that provide goods and services necessary for drilling and production.⁵ As a result, the operator may spend thousands of dollars in the drilling and completion of a well without securing sufficient collateral to hedge against the possible insolvency of any non-operating party.⁶ The financial results are potentially disastrous for the operating party.⁷

The operator can minimize its financial exposure, however, by invoking language contained in article VII-B of the Model Form Operating Agreement.⁸ Article VII-B, entitled "Liens and Payment Defaults," provides as follows:

Each Non-Operator grants to Operator a lien upon its oil and gas rights in the Contract Area, and a security interest in its share of oil and/or gas when extracted and its interest in all equipment, to secure payment of its share of expense, together with interest thereon. . . . To the extent that Operator has a security interest under the Uniform Commercial Code of the state, Operator shall be entitled to exercise the rights and remedies of a secured party under the Code.⁹

6 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 921.2, at 404 (1985) (quoting Operators Agreement, Seeligson Field Unit, § 204).

4. A run has been defined as "[o]il or gas, measured at standard conditions, moved off the lease or unit for sale." 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 787 (1984) (citing IOCC, A SUGGESTED FORM OF GENERAL RULES AND REGULATIONS FOR THE CONSERVATION OF OIL AND GAS, Rule III (1960)).

5. The operator's duties are typically set forth in the operating agreement, although the details of operating agreements vary considerably. See 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 503.2, at 576.9 to 576.10 (1985) (describing the typical provisions of operating agreements). According to the Model Form Operating Agreement, the operator "shall conduct and direct and have full control of all operations on the Contract Area. . . ." A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. V-A.

6. The author of this Article has assumed that substantial value can be attached to the working interests even though the venture may prove unsuccessful.

7. Some states have enacted statutory liens that may protect the operating party. See, e.g., N.D. CENT. CODE § 35-24-02 (1980) (person who furnishes any material or services for oil and gas purposes is entitled to a lien to secure the amount due); OKLA. STAT. ANN. tit. 42, § 144 (West 1979) (granting a statutory lien to any person who performs services or furnishes materials for the production of oil and gas); WYO. STAT. § 29-3-103 (1981) (granting a lien to secure payment for "constructing . . . operating, completing or repairing any wells, mines or quarries"). There is some question, however, whether these statutes adequately protect the operator. See generally Note, *Oil and Gas: Security Interests Under the A.A.P.L. Form 610-1977 Model Form Operating Agreement*, 36 OKLA. L. REV. 916, 922-24 (1983) (discussing the application of Oklahoma's lien statute to the operating party of the Model Agreement).

8. See generally Clark & Sachs, *Oil and Gas Financing Under The Uniform Commercial Code As Enacted in Colorado*, 43 DEN. L.J. 129 (1966) (discussing means by which a creditor in an oil and gas venture can protect its interests); Note, *Oil and Gas: A.A.P.L. Form 510 Model Form Operating Agreement: Imposing Limitations on the Operator's Ability to Require Contribution from Nondefaulting Nonoperators*, 36 OKLA. L. REV. 730 (discussing the interaction between the UCC and the Operating Agreement).

9. A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B.

It is the position of the author of this Article that article VII-B can, with proper legal handling, protect an operator from the financial hazards accompanying an insolvent non-operator.

II. APPLICABILITY OF ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE TO THE MODEL AGREEMENT

Article 9 of the Uniform Commercial Code (UCC) regulates the creation and enforceability of "any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper, or accounts. . . ." ¹⁰ Thus, Article 9 governs the security provisions contained in article VII-B of the Model Agreement if two requirements are satisfied: the parties must intend that article VII-B create a security interest; and the security interest created must apply to personal property or fixtures. ¹¹

"Security interest" is defined in subsection 1-201(37) of the UCC as "an interest in personal property or fixtures which secures payment or performance of an obligation." ¹² In the context of an oil and gas venture, the operator incurs expenses for the drilling, completion, and operation of a well. ¹³ Under the Model Agreement, however, non-operators assume a proportional share of these expenses. ¹⁴ In order to secure performance of this obligation, article VII-B of the Model Agreement grants the operator an interest in the non-operators' proportion of oil and gas produced, equipment used to produce that oil and gas, and rights to production of oil and gas that remain in the ground. ¹⁵ Thus, the

10. U.C.C. § 9-102(1)(a) (1978) [N.D. CENT. CODE § 41-09-02(1)(a) (1983)]. The official comment to § 9-102 of the UCC states that the purpose of § 9-102 "is to bring all consensual security interests in personal property and fixtures under this Article, except for certain types of transactions excluded by Section 9-104." U.C.C. § 9-102 official comment (1978).

11. See U.C.C. § 9-102 (1978) [N.D. CENT. CODE § 41-09-02 (1983)].

12. U.C.C. § 1-201(37) (1978) [N.D. CENT. CODE § 41-01-11(37) (1983)]. The definitions set forth in § 1-201 apply to Article 9. See U.C.C. § 1-201 (1978) (introductory sentence) (definitions applicable to the entire Code unless the context requires otherwise).

13. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-A. Article VII-A of the Model Agreement, entitled "Liability of Parties," provides, in relevant part, as follows:

The liability of the parties shall be several, not joint or collective. Each party shall be responsible only for its obligations, and shall be liable only for its proportionate share of the costs of developing and operating the Contract Area. Accordingly, the liens granted among the parties in Article VII.B are given to secure only the debts of each severally.

Id.

14. See *id.* For the text of article VII-A, which sets forth the liabilities of the parties, see *supra* note 13.

15. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B. For the relevant provisions of article VII-B, see *supra* text accompanying note 9.

“grant” language of the Model Agreement evidences a clear intent to create a security interest.¹⁶

An issue arises, however, concerning the second requirement for applicability of Article 9: whether the collateral granted to secure the obligations of non-operators constitutes an “interest in personal property or fixtures.”¹⁷ This issue is compounded by the fact that the Model Agreement contemplates three different types of collateral: (1) oil and gas that have been produced; (2) equipment used to extract the oil and gas; and (3) oil and gas that remains underground.¹⁸ This Article will proceed to analyze whether these three types of collateral constitute either personal property or fixtures as defined under Article 9 of the UCC.

A. SECURITY INTEREST IN OIL AND GAS THAT HAVE BEEN PRODUCED

Although not expressly addressed by the UCC, commentators appear unanimous in the conclusion that oil and gas, after extraction, are personal property subject to Article 9.¹⁹ Under a former version of Article 9, this conclusion was predicated upon subsection 9-204(2)(b), which stated that a security interest in oil and gas did not attach until after extraction.²⁰ Once the minerals were extracted, however, they were subject to attachment.²¹ Since oil and gas were subject to attachment upon extraction, they must have been considered either personal property or fixtures.²²

The 1978 version of the Code also supports the conclusion that

16. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B (containing the grant language of the Model Agreement). See generally Note, *Oil and Gas: A.A.P.L. Form 510 Model Form Operating Agreement: Imposing Limitations on the Operator's Ability to Require Contribution from Nondefaulting Nonoperators*, 36 OKLA. L. REV. 730, 731-33 (1983) (discussing the history of the Model Agreement and stating that the operator is granted a security interest).

17. See U.C.C. § 9-102(1)(a) (1978) [N.D. CENT. CODE § 41-09-02(1)(a) (1983)] (providing that Article 9 applies to any transaction intended to create a security interest in personal property or fixtures).

18. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B. For the language of article VII-B, see *supra* text accompanying note 9.

19. See, e.g., B. CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 13.3[1] (1980) (“[t]here is no doubt that the oil and gas, once extracted, will be considered personal property subject to Article 9”); Clark & Sachs, *Oil and Gas Financing Under The Uniform Commercial Code As Enacted in Colorado*, 43 DEN. L.J. 129, 135 (1966) (“it is clear under the Code that the extracted hydrocarbons become personally subject to the rules of Article 9”).

20. See U.C.C. § 9-204(2)(b) (1962) (amended 1972). See generally B. CLARK, *supra* note 19, ¶ 13.3[1] (discussing the applicability of Article 9 to extracted oil and gas under the former Code).

21. See B. CLARK, *supra* note 19, ¶ 13.3[1] (stating that the former provision strongly suggested that a security interest could attach to the minerals after extraction); see also U.C.C. § 9-204 comment 4 (1962) (amended 1972) (stating that subsection 2 indicates when a debtor has sufficient rights in collateral so that a security interest may attach).

22. See U.C.C. § 9-102(1)(a) (1978) [N.D. CENT. CODE § 41-09-02(1)(a) (1983)] (providing that Article 9 applies only to security interests in personal property or fixtures).

oil and gas are personal property within the meaning of Article 9.²³ Section 9-102 provides that Article 9 applies “to any transaction . . . which is intended to create a security interest in personal property or fixtures *including goods*. . . .”²⁴ The definition of “goods” contained in subsection 9-105(h) specifically excludes oil and gas, prior to extraction.²⁵ By negative implication, then, oil and gas that have been extracted are within the definition of goods.²⁶ Thus, according to section 9-102, extracted oil and gas constitute personal property. Because article VII-B of the Model Agreement evidences an intent of the parties to create a security interest, and because extracted oil and gas constitute personal property, Article 9 applies to the security interest in extracted oil and gas granted by article VII-B of the Model Agreement.²⁷

B. SECURITY INTEREST IN EQUIPMENT

The equipment used in drilling and completing a well includes storage tanks, wellhead equipment, drilling rigs, pipes, pumps, and well-servicing equipment.²⁸ Each of these pieces of equipment constitutes goods as expressly provided in subsection 9-109(2) of the UCC, and thus are personal property.²⁹ Moreover, some of the equipment falls within the definition of “fixtures” as well as the definition of “personal property.”³⁰ Whether the equipment is

23. See generally B. CLARK, *supra* note 19, ¶ 13.3[1] (concluding that, under the 1978 version of the UCC, extracted oil and gas constitutes personal property).

24. U.C.C. § 9-102(1)(a) (1978) (emphasis added) [N.D. CENT. CODE § 41-09-02 (1983)].

25. U.C.C. § 9-105(1)(h) (1978) [N.D. CENT. CODE § 41-09-05(1)(h) (1983)] (“[g]oods’ . . . does not include . . . minerals or the like (including oil and gas) before extraction”).

26. B. CLARK, *supra* note 19, ¶ 13.3[1]; see also Northwest Trust Co. v. Buckeye Petroleum Co., No. 11,069, slip op. at 8-9 (extracted oil and gas are considered personal property).

27. See U.C.C. § 9-102(1)(a) (1978) [N.D. CENT. CODE § 41-09-02(1)(a) (1983)] (Article 9 applies to all transactions intended to create a security interest in personal property or fixtures).

28. See B. CLARK, *supra* note 19, ¶ 13.4.

29. See U.C.C. § 9-109(2) (1978) [N.D. CENT. CODE § 41-09-09(2) (1983)]. Subsection 9-109 provides, in relevant part, as follows:

Goods are . . . “equipment” if they are used or bought for use primarily in business (including farming or a profession) or by a debtor who is a non-profit organization or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products or consumer goods. . . .

U.C.C. § 9-109(2) (1978). The machinery used to drill and complete a well seems to fit within the definition of equipment set forth in subsection 9-109(2). See *id.* Therefore, the equipment used to extract oil and gas constitutes “goods.” See *id.*; see also *id.* § 9-105(1)(h) (1978) [N.D. CENT. CODE § 41-09-05(1)(h) (1983)] (“[g]oods’ includes all things which are movable at the time the security interest attaches”).

30. See U.C.C. § 9-313(1)(a) (1978) [N.D. CENT. CODE § 41-09-34(1)(a) (1983)] (defining “fixtures”). According to subsection 9-313(1)(a), “goods are fixtures when they become so related to particular real estate that an interest in them arises under real estate law.” U.C.C. § 9-313(1)(a) (1978). The Code expressly provides that fixtures fall within the definition of goods. See *id.* § 9-105(1)(h) [N.D. CENT. CODE § 41-09-05(1)(h) (1983)].

classified as a fixture will be important in the subsequent discussions concerning perfection.³¹ At this point, it suffices to note that the equipment used to extract oil and gas constitutes "personal property or fixtures" within the meaning of Article 9, and thus Article 9 applies to this item of collateral.³²

C. INTEREST IN OIL AND GAS THAT ARE YET TO BE PRODUCED

While Article 9 applies to security interests in goods, subsection 9-105(h) expressly provides that "'goods' . . . does not include . . . minerals or the like (including oil and gas) before extraction."³³ It appears, then, that Article 9 was not intended to apply to security interests in oil and gas that remain underground.³⁴ Moreover, the conclusion that an interest in underground oil and gas is an interest in real property has received overwhelming support from jurisdictions that have considered the issue.³⁵

In *Ingram v. Ingram*³⁶ for example, the defendant had assigned his interest in an oil and gas lease to secure a bank loan.³⁷ The defendant subsequently defaulted on his alimony and child support obligations, and his wife levied execution on the lease.³⁸ The Kansas Supreme Court determined that which party, the wife or the bank, had a superior interest in the oil and gas lease depended upon "whether or not the assignment of an oil and gas lease for security purposes is subject to the provisions of the Uniform Commercial Code."³⁹ In analyzing the issue, the court noted that an oil and gas lease is sometimes considered an interest in personal

31. See *infra* notes 101-19 and accompanying text.

32. See U.C.C. § 9-102(1)(a) (1978) [N.D. CENT. CODE § 41-09-02(1)(a) (1983)] (Article 9 applies to any transaction intended to create an interest in personal property or fixtures).

33. U.C.C. § 9-105(1)(h) (1978) [N.D. CENT. CODE § 41-09-05(1)(h) (1983)].

34. See U.C.C. § 9-105(1)(h) (1978) [N.D. CENT. CODE § 41-09-05(1)(h) (1983)]; see also B. CLARK, *supra* note 19, ¶ 13.2 (stating that Article 9 attempts to make it clear "that the law of real estate mortgages should govern security in minerals prior to extraction"); J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 22-6, at 890 (2d ed. 1980) ("Article [9] does not apply to oil, gas or other minerals before extraction").

35. See, e.g., *Callahan v. Martin*, 3 Cal. 2d 110, 113, 43 P.2d 788, 790 (1935) (an assignment of an undivided interest in oil rights is an assignment of an interest in real property); *Ingram v. Ingram*, 214 Kan. 415, 423, 521 P.2d 254, 260 (1974) (interest in unextracted oil and gas is subject to the real estate recording laws); *Petroleum Exch., Inc. v. Poynter*, 64 N.W.2d 718, 722 (N.D. 1954) ("oil, gas and mineral leases are conveyances of interests in real property"). See generally B. CLARK, *supra* note 19, ¶ 13.2[2] (discussing cases that have concluded that an interest in unextracted oil and gas constitutes an interest in real property).

According to one commentator, New York is the only jurisdiction that still classifies an oil and gas lease as personal property. See B. CLARK, *supra* note 19, ¶ 13.2[2]. The New York position, however, is based upon a statute which explicitly states that oil and gas leases constitute personal property. See N.Y. GEN. CONSTR. LAW § 39 (McKinney 1951).

36. 214 Kan. 415, 521 P.2d 254 (1974).

37. *Ingram v. Ingram*, 214 Kan. 415, 416, 521 P.2d 254, 256 (1974).

38. *Id.*

39. *Id.* at 418, 521 P.2d at 257.

property, and at other times is considered an interest in real property.⁴⁰ Upon reviewing relevant UCC provisions, however, the court concluded that “[o]il and gas are considered to be part of the real estate until they are extracted,” and held that Article 9 does not apply to an interest in oil and gas that remain underground.⁴¹

Since an interest in underground oil and gas is considered an interest in real property, subsection 9-104(j) provides that the provisions of Article 9 are not applicable to this aspect of the Model Agreement.⁴² Rather, the interest in underground oil and gas is governed by the law of real estate mortgages.⁴³ In subsequent sections, this Article will analyze how the operator can use mortgage statutes to protect its interest in underground oil and gas.⁴⁴ Before doing so, however, the Article will examine the steps that an operator must take to protect its Article 9 security interests in oil and gas that have been produced and in the equipment used to extract those minerals.

III. ENFORCEABILITY AMONG THE PARTIES OF THE SECURITY INTEREST IN EQUIPMENT AND OIL AND GAS THAT HAVE BEEN PRODUCED — ATTACHMENT

Having established that provisions contained in article VII-B of the Model Agreement concerning equipment and oil and gas that have been produced are governed by Article 9 of the UCC, it is necessary to consider whether the security interests granted by those provisions are enforceable against a non-operator. An operator may enforce a UCC security interest against a defaulting non-operator only if the interest has “attached” as defined by section 9-203 of the UCC.⁴⁵ Section 9-203 provides three basic

40. *Id.* at 420, 521 P.2d at 258.

41. *Id.* at 423, 521 P.2d at 260. The court specifically relied, in part, on Kansas’ version of § 9-204 which stated that the debtor has no rights in oil, gas or minerals until they are extracted. *Id.* The court interpreted this provision as manifesting the clear intent that any type of interest related to unextracted oil and gas remain governed by real estate recording laws. *Id.* The court also noted that Kansas’ version of § 9-104(j) of the UCC states that the Code does not apply to the creation or transfer of an interest in real property. *Id.* at 422-23, 521 P.2d at 260.

42. See U.C.C. § 9-104(j) (1978) [N.D. CENT. CODE § 41-09-04(10) (Supp. 1985)]. Section 9-104 provides, in relevant part, as follows: “This Article does not apply . . . except to the extent that provision is made for fixtures in Section 9-313, to the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder. . . .” U.C.C. § 9-104(j) (1978).

43. For a discussion of cases concluding that an interest in underground oil and gas is governed by the law of real estate mortgages, see *supra* notes 35-42 and accompanying text.

44. See *infra* notes 120-39 and accompanying text.

45. See U.C.C. § 9-203 (1978) [N.D. CENT. CODE § 41-09-16 (Supp. 1985)]. Section 9-203 sets forth the steps a party must take to create an enforceable Article 9 security interest. J. WHITE & R.

requirements that must be satisfied for a security interest to attach: (1) there must be a security agreement; (2) the secured party must give the debtor value in exchange for the voluntary granting of the security interest; and (3) the debtor must have rights in the collateral.⁴⁶

A. SECURITY AGREEMENT

The first requirement for attachment of the security interests granted to the operator under article VII-B of the Model Agreement is that a security agreement exist between the operator and non-operators.⁴⁷ While "no magic words or precise form" are necessary to establish a security agreement,⁴⁸ the parties must intend to grant an interest in property as security for the performance of an obligation.⁴⁹ If the security agreement provides for possession of the collateral by the operator, and if the operator actually retains possession of the collateral, the security agreement need not be in writing.⁵⁰ If the agreement provides instead for possession of the collateral by the non-operator or by a third party, however, the security agreement must be in writing, it must be signed by the non-operator, and it must contain a description of the

SUMMERS, *supra* note 34, § 23-1; see U.C.C. § 9-203(1)(a)-(c). Once the steps enumerated in § 9-203(1) are taken, the security interest comes into existence and is enforceable against the debtor. J. WHITE & R. SUMMERS, *supra* note 34, § 23-1; see U.C.C. § 9-203(2). The drafters of Article 9 labeled this event "attachment." J. WHITE & R. SUMMERS, *supra* note 34, § 23-1.

46. See U.C.C. § 9-203(1)(a)-(c) (1978) [N.D. CENT. CODE § 41-09-16(1)(a)-(c) (Supp. 1985)]. Subsection 9-203(1) of the UCC provides as follows:

Subject to the provisions of Section 4-208 on the security interest of a collecting bank, Section 8-321 on security interests in securities and Section 9-113 on a security interest arising under the Article on Sales, a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless:

- (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned;
- (b) value has been given; and
- (c) the debtor has rights in the collateral.

U.C.C. § 9-203(1) (1978).

47. See U.C.C. § 9-203(1)(a) (1978). For the text of § 9-203(1), see *supra* note 46.

48. J. WHITE & R. SUMMERS, *supra* note 34, § 23-3, at 906.

49. See U.C.C. § 1-201(37) (1978) [N.D. CENT. CODE § 41-01-11(37) (Supp. 1985)]. Subsection 1-207(37) of the UCC defines a security interest as "an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1978). Additionally, § 9-102(1)(a) provides that Article 9 applies "to any transaction . . . which is intended to create a security interest in personal property or fixtures." *Id.* § 9-102(1)(a) [N.D. CENT. CODE § 41-09-02(1)(a) (1983)].

50. See U.C.C. § 9-203(1)(a) (1978) [N.D. CENT. CODE § 41-09-16(1)(a) (1983)]. Comment 1 to § 9-203 states that "the agreement must be in writing unless the collateral is in the possession of the secured party." U.C.C. § 9-203 official comment 1 (1978). For a discussion of the operator's possession of the collateral, see *infra* notes 76-85 and accompanying text.

collateral.⁵¹ It is also recommended, though not required by the UCC, that the security agreement contain a description of the land from which the oil and gas are to be produced.⁵²

Though it may be argued that the operator is in possession of the covered collateral⁵³ — the equipment and extracted oil and gas — this argument is unnecessary because the Model Agreement probably constitutes a writing that satisfies the requirements of the UCC. According to the Model Agreement, which is in writing and signed by all non-operators, a non-operator grants to the operator an interest in collateral “to secure payment of its share of expense, together with interest thereon.”⁵⁴ The collateral is described in the Model Agreement as “its [the non-operator’s] share of oil and/or gas when extracted and its [the non-operator’s] interest in all equipment.”⁵⁵ The description of the non-operator’s “share of oil and/or gas when extracted” is expanded in exhibit A of the Model Agreement.⁵⁶ The Model Agreement also describes the contract area, thereby providing the additional protection of describing the land from which the oil and gas are to be removed.⁵⁷ Because the Model Agreement is a written security agreement, signed by the debtor, that adequately describes the collateral involved, the first requirement of attachment under the UCC is satisfied.⁵⁸

51. See U.C.C. § 9-203(1)(a). Subsection 9-203(1)(a) provides that a nonpossessory security interest is effective only if “the debtor has signed a security agreement which contains a description of the collateral.” *Id.* For the text of § 9-203(1), see *supra* note 46. Section 9-110 provides that “any description of [collateral] is sufficient whether or not it is specific if it reasonably identifies what is described.” *Id.* § 9-110 [N.D. CENT. CODE § 41-09-10 (1983)].

52. A prior version of § 9-203 required a description of the land in a security agreement covering minerals to be extracted. See UNIF. COMMERCIAL CODE general comment D-1, 3 U.L.A. 20 (1981). The current version of § 9-203(1)(b) does not require a description of the land from which minerals are to be extracted. See U.C.C. § 9-203 (1978) [N.D. CENT. CODE § 41-09-16 (Supp. 1985)] (requiring a land description only if the security interest covers crops or timber).

53. For a discussion of possession of the collateral by the operator, see *infra* notes 76-85 and accompanying text.

54. A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B.

55. *Id.*

56. *Id.* art. II. Article II of the Model Agreement provides, in pertinent part, as follows: “The following exhibits, as indicated below and attached hereto, are incorporated in and made a part hereof: A. Exhibit “A,” shall include the following information: (1) Identification of lands subject to this agreement, . . . (4) Oil and gas leases and/or oil and gas interests subject to this agreement. . . . *Id.*”

57. *Id.* For the relevant language of article II, see *supra* note 56.

58. One commentator has noted that the grant language of the Model Agreement contains numerous deficiencies that may, in a particular state, inhibit the enforceability of security interests created on behalf of the operator. See Heaney, *The Joint Operating Agreement, the AFE and COPAS — What They Fail to Provide*, 29 ROCKY MTN. MIN. L. INST. 743, 752-62 (1983). Heaney notes that the primary deficiency of the Model Agreement in states that have adopted the UCC is its failure to create a security interest in the accounts and general intangibles that arise upon the sale of the non-operator’s interest in the extracted oil and gas. *Id.* at 759-60. Heaney also contends that the Model Agreement does not clearly provide that the security interest covers after-acquired property or proceeds. *Id.* at 760. Heaney proposes the following provisions to ensure that the security interest granted by the Model Agreement provides all of the rights and remedies available under Article 9 of the UCC:

B. VALUE GIVEN BY THE CREDITOR

The second requirement for attachment of a security interest under the UCC is that the secured party must give value to the debtor.⁵⁹ Subsection 1-201(44)(d) of the Code provides that a secured party gives value for a security interest if it acquires that security interest "in return for any consideration sufficient to support a simple contract."⁶⁰ A secured party may also give the debtor value by advancing credit, or by entering a binding commitment to advance credit in the future.⁶¹

Pursuant to the Model Agreement, the operator is obligated to contract for the work to be done on the well, negotiate the purchase of runs,⁶² and oversee the well's general operation.⁶³ Moreover, the

To further secure its share of expenses incurred under this Operating Agreement, together with interest thereon at the rate provided on Exhibit "C", each Non-Operator grants to Operator a security interest in all of its interest now owned or hereafter acquired in and to (i) all equipment, (ii) all hydrocarbons severed and extracted from or attributable to the properties described in Exhibit "A", (iii) all accounts (including, but not limited to, accounts resulting from the sale of hydrocarbons at the wellhead), contract rights and general intangibles arising in connection with the sale or other disposition of any hydrocarbons, (iv) fixtures and (v) all proceeds and products of all such properties. Operator shall have no obligation to preserve rights against prior parties.

Id. at 761. Heaney also recommends that the following provision be inserted on the cover of the Model Agreement:

This instrument is intended to be used as a financing statement. The oil and gas interests included within the collateral subject to the security interest herein granted will be financed at the wellheads of the wells located on the properties described on Exhibit "A" attached hereto. This financing statement is to be filed for record, among other places, in the real estate records of the counties in which such properties are located. This instrument secures future advances and constitutes, among other things, a fixture filing.

Id. at 761-62.

59. See U.C.C. § 9-203(1)(b) (1978) [N.D. CENT. CODE § 41-09-16(1)(b) (Supp. 1985)]. For the text of § 9-203(1), see *supra* note 46.

60. U.C.C. § 1-201(44)(d) (1978) [N.D. CENT. CODE § 41-01-11(44)(d) (Supp. 1985)]. Subsection 1-201(44) of the UCC defines "value" as follows:

Except as otherwise provided with respect to negotiable instruments and bank collections . . . a person gives "value" for rights if he acquires them

- (a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a chargeback is provided for in the event of difficulties in collection; or
- (b) as security for or in total or partial satisfaction of a pre-existing claim; or
- (c) by accepting delivery pursuant to a pre-existing contract for purchase; or
- (d) generally, in return for any consideration sufficient to support a simple contract.

U.C.C. § 1-201(44) (1978).

61. U.C.C. § 1-201(44)(a) (1978) [N.D. CENT. CODE § 41-01-11(44)(a) (Supp. 1985)]. For the text of § 1-201(44)(a), see *supra* note 60.

62. For a definition of "runs," see *supra* note 4.

63. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. V-A. Article V-A states that the operator "shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement." *Id.*

Model Agreement obligates the operator to pay and discharge all expenses incurred in the development of the contract area.⁶⁴ The operator may then charge each of the parties with their respective proportionate shares.⁶⁵ These obligations may properly be regarded as "consideration sufficient to support a simple contract," or as the extension of credit to non-operators. Thus, the operator gives "value" in return for the security interest granted by the Model Agreement, and the second requirement for attachment is fulfilled.

C. DEBTOR HAS RIGHTS IN THE COLLATERAL

The final requirement for attachment is that the debtor have rights in the collateral.⁶⁶ The Model Agreement provides that the non-operators are proportionate owners of the equipment and materials required in the drilling venture and that "the parties shall also own all production of oil and gas from the Contract Area."⁶⁷ The non-operators clearly have rights in the collateral by virtue of these ownership interests set forth in the Model Agreement.⁶⁸ The Model Agreement lends additional support to the proposition that the non-operators have rights in the collateral by providing that the non-operators may take their share of production in kind.⁶⁹

It should be noted that the oil and gas have not been produced, nor has the equipment been purchased, at the time the Model Agreement is entered. Hence, the non-operators have no rights in the collateral until that time. However, subsection 9-204(1) of the UCC provides that "a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."⁷⁰ This has led one commentator to

64. See *id.* art. VII-C. According to article VII-C, the "Operator shall promptly pay and discharge expenses incurred in the development and operation of the Contract Area . . . and shall charge each of the parties hereto with their respective proportionate shares." *Id.*

65. *Id.* One commentator has discussed the problems encountered when an operator finances the production of oil and gas. See Heaney, *supra* note 58, at 754-62. Heaney contends that, if parties refuse to pay their share of costs as operations continue, "the participant with the deepest pocket will always be left bearing the costs of an operation." *Id.* at 756.

66. See U.C.C. § 9-203(1)(c) (1978) [N.D. CENT. CODE § 41-09-16(1)(c) (Supp. 1985)]. For the text of subsection 9-203(1), see *supra* note 46. See also *Northwestern Bank v. First Va. Bank*, 585 F. Supp. 425, 429 (W.D. Va. 1984) ("debtor must acquire some ownership interest in the collateral before a valid security interest arises").

67. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. III-B.

68. See *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 214 (Okla. 1977) (security agreement may attach if the debtor has any rights in the collateral other than mere "naked possession").

69. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VI-C. Article VI-C provides, in relevant part, that "[e]ach party shall take in kind or separately dispose of its proportionate share of all oil and gas produced from the Contract Area." *Id.*

70. U.C.C. § 9-204(1) (1978) [N.D. CENT. CODE § 41-09-17(1) (Supp. 1985)]. The express purpose of § 9-204(1) is to make "clear that a security interest arising by virtue of an after-acquired

observe that "the creditor's interest attaches at the time of the original agreement, even to the after-acquired inventory or accounts."⁷¹

IV. ENFORCEABILITY OF THE SECURITY INTEREST IN EQUIPMENT AND EXTRACTED OIL AND GAS AGAINST THIRD PARTIES — PERFECTION

Once the formal requirements of attachment are met, a security interest is valid and enforceable against the non-operating debtors.⁷² In order to assert priority over third party creditors, however, the operator must take the additional step of perfecting its interest under Article 9.⁷³ The method by which an operator may perfect its security interest depends upon the nature of the collateral involved.⁷⁴

property clause has equal status with a security interest in collateral in which the debtor has rights at the time value is given under the security agreement." U.C.C. § 9-204 official comment 1 (1978).

71. J. WHITE & R. SUMMERS, *supra* note 34, § 23-4, at 916. The authors ask the rhetorical question: "When does the creditor's interest in the after-acquired property attach?" *Id.* The authors respond with the following statements:

It might seem that it could not attach until the debtor later acquired it, for not until then could he have "rights in the collateral". Yet many courts have held that where the original security is created in an "entity" such as inventory or accounts and at least some items of collateral are then owned by the debtor, the creditor's interest attaches at the time of the original agreement, even to the after-acquired inventory or accounts.

Id. (footnote omitted). *But see* Heaney, *supra* note 58, at 760. Heaney argues that one of the primary deficiencies of the Model Agreement is that "it fails to create a security interest in the accounts and general intangibles which arise upon the sale of the non-operator's interest in the hydrocarbons produced." *Id.* Heaney proposes that certain provisions should be inserted in the Model Agreement to remedy this situation. For the text of Heaney's proposed amendment to the Model Agreement, see *supra* note 58.

72. See U.C.C. § 9-203(2) (1978) [N.D. CENT. CODE § 41-09-16(2) (Supp. 1985)]. Subsection 9-203(2) provides that, once attachment occurs, the security interest is "enforceable against the debtor." U.C.C. § 9-203(2) (1978). The attachment of a security interest also makes the security interest enforceable against third parties. See *id.* § 9-203(1). However, the UCC contains several important exceptions to the general rule that the secured party with an attached security interest takes the collateral to the exclusion of third parties. For example, many third parties will defeat or take priority over an attached but unperfected security interest. See *id.* § 9-301 [N.D. CENT. CODE § 41-09-22 (1983)] (persons who take priority over an unperfected security interest). Section 9-301 of the UCC is beyond the scope of this Article. Its effect on the unperfected secured creditor, however, should always be considered.

73. See U.C.C. § 9-301 (1978) [N.D. CENT. CODE § 41-09-16 (Supp. 1985)] (enumerating parties who may prevail over an unperfected security interest). In addition to being subordinate to some third party creditors, an unperfected security interest cannot be enforced against the trustee in bankruptcy proceedings. See 11 U.S.C. § 544 (1982 & Supp. II 1984) (giving the trustee status as an hypothetical lien creditor); see also U.C.C. § 9-301(1)(b) (1978). Subsection 9-301(1)(b) provides, in relevant part, as follows: "[A]n unperfected security interest is subordinate to the rights of . . . a person who becomes a lien creditor before the security interest is perfected." *Id.* See generally J. WHITE & R. SUMMERS, *supra* note 34, § 23-5 (discussing perfection in general). White and Summers state that "a secured party who perfects prior to bankruptcy is likely to have the right to snatch the collateral out of the trustee's hands, but an unperfected secured party will invariably have to eat from the general creditor's trough in bankruptcy." *Id.* at 918.

74. See B. Clark & J. Sachs, *supra* note 19, at 131.

A. PERFECTION OF THE SECURITY INTEREST IN EXTRACTED OIL AND GAS

As previously discussed, extracted oil and gas constitute "goods" as the term is used in Article 9.⁷⁵ Section 9-305 provides that "[a] security interest in . . . goods . . . may be perfected by the secured party's taking possession of the collateral."⁷⁶ Thus, if the operator's security interest has "attached," and if the operator may be considered to have possession of the extracted oil and gas, then his security interest in that item of collateral would be perfected.⁷⁷

An argument for the proposition that an operator is in possession of the extracted oil and gas may be based upon the operator's full rights of control and custody of the contract area as granted in the Model Agreement.⁷⁸ Full control and custody of the contract area, it may be argued, would extend to extracted oil and gas stored within that area. Hence, an operator could be considered a creditor in possession of that collateral. Additional support for the argument that an operator is in possession of oil and gas extracted from the contract area may be found in article VI-C of the Model Agreement.⁷⁹ Article VI-C provides that "[e]ach party shall take in kind or separately dispose of its proportionate share of all oil and gas produced from the Contract Area."⁸⁰ Until a non-operator undertakes an affirmative act that may constitute "taking" or "disposing" of the extracted oil and gas, the extracted oil and gas may be considered to remain in the possession of the operator.

75. See *supra* notes 19-27 and accompanying text.

76. U.C.C. § 9-305 (1978) [N.D. CENT. CODE § 41-09-26 (Supp. 1985)]. Section 9-305 limits perfection by creditor possession of the collateral by providing as follows: "A security interest is perfected by possession from the time possession is taken without a relation back and continues only so long as possession is retained, unless otherwise specified in this Article." U.C.C. § 9-305 (1978).

77. See U.C.C. § 9-305 (1978) [N.D. CENT. CODE § 41-09-26 (Supp. 1985)]. See generally J. WHITE & R. SUMMERS, *supra* note 34, § 23-10 (discussing perfection by creditor possession).

78. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. V-A. For the relevant text of article V-A, see *supra* note 63. This argument is also consistent with the intent of the parties as reflected by the lien provisions of article VII-B of the Model Agreement. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B. Moreover, the argument that the operator is a creditor in possession is also consistent with North Dakota's provisions dealing with disputes between individuals who have pooled their interests in a particular tract of land. See N.D. CENT. CODE § 38-08-08 (Supp. 1985). Subsection 38-08-08(2) provides, in relevant part, as follows:

If one or more of the owners shall drill and operate, or pay the expenses of drilling and operating the well for the benefit of others, then, the owner or owners so drilling or operating shall, upon complying with the terms of section 38-08-10, have a lien on the share of production from the spacing unit accruing to the interest of each of the other owners for the payment of his proportionate share of such expenses.

Id.

79. See A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VI-C.

80. *Id.*

However, arguing that the operator may perfect his security interest in extracted oil and gas by possession seems to ignore specific Article 9 provisions that address the perfection of security interests in oil and gas.⁸¹ Each of these provisions indicate, without mandating, that an "attached" security interest in extracted oil and gas is properly perfected through the filing of a financing statement. Subsection 9-402(5), for example, provides specific information that must be contained in financing statements covering security interests in oil and gas.⁸² Additionally, subsection 9-401(1)(b) requires that "[w]hen the collateral is . . . minerals or the like (including oil and gas) . . . [then the proper place to file is] in the office where a mortgage on the real estate would be filed or recorded."⁸³ The purpose of this latter provision is to ensure that any security interest in oil and gas is disclosed by a search of the real estate records covering the contract area.⁸⁴ This purpose would be thwarted if the operator were permitted to perfect his security interest by claiming that he is a creditor in possession.

Because it appears that the drafters of the UCC intended security interests in extracted oil and gas to be perfected by filing,⁸⁵ it is recommended that an operator take the precaution of filing a financing statement. Subsection 9-402(1) of the UCC provides that a financing statement must contain the following information: (1) the names of the debtor and the secured party; (2) the signature of the debtor; (3) the address of the debtor and of the secured party; and (4) a description of the collateral.⁸⁶ Additionally, subsection 9-402(5) provides that, if the financing statement is to cover oil and gas, the following information must also be included:

81. See U.C.C. § 9-401(1) (all three alternatives) (1978) [N.D. CENT. CODE § 41-09-40(1)(b) (1983)]; U.C.C. § 9-402(5) (1978) [N.D. CENT. CODE § 41-09-41(5) (1983)].

82. See U.C.C. § 9-402(5) (1978) [N.D. CENT. CODE § 41-09-41(5) (1983)]. For the relevant text of § 9-402(5), see *infra* text accompanying note 87.

83. U.C.C. § 9-401(1)(b) (second and third alternative; the first alternative contains a similar provision in § 9-401(1)(a) (1978)) [N.D. CENT. CODE § 41-09-40(1)(b) (1983)].

84. See U.C.C. § 9-402(5) official comment 5 (1978). According to official comment 5 to § 9-402(5), "[t]he . . . description of real estate must be sufficient so that the . . . financing statement will fit into the real estate search system and . . . be found by a real estate searcher." *Id.*

85. See *supra* notes 81-84 and accompanying text.

86. See U.C.C. § 9-402(1) (1978) [N.D. CENT. CODE § 41-09-41(1) (1983)]. Subsection 9-402(1) of the UCC provides, in relevant part, as follows:

A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral. . . . When the financing statement covers . . . minerals or the like (including oil and gas) . . . the statement must also comply with subsection (5).

U.C.C. § 9-402(1) (1978); see also *id.* § 9-402(5). For the relevant text of § 9-402(5), see *infra* text accompanying note 87.

(1) that the financing agreement covers oil and gas interests; (2) the recital that the financing agreement is to be filed for record in the real estate records; (3) a description of the real estate sufficient that, if it were a mortgage of the real estate, it would give constructive notice of the mortgage under State law; and (4) if the debtor does not have an interest of record in the real estate, the name of the record owner.⁸⁷

The Model Agreement, with slight modification, may conform to the requirements of Article 9 for a financing statement of an interest in oil and gas.⁸⁸ The practitioner should compare each Model Agreement to the above list of elements to ensure that it contains all information necessary to serve as a financing statement. If an operator desires additional protection to ensure that the formal requirements of a financing statement are present, he may file a standard form UCC financing statement along with the Model Agreement.⁸⁹

If all required information is present, the Model Agreement may be filed as a financing statement, and it becomes necessary to determine the proper location for filing. Issues concerning where to file "always begin with section 9-401."⁹⁰ The UCC provides three alternatives to subsection 9-401.⁹¹ Each alternative provides the appropriate location to file the financing statement.⁹² The appropriate location depends on the classification of the collateral involved.⁹³ Each alternative provides that "when the collateral . . . is minerals or the like (including oil and gas) . . . then [the proper place to file is] in the office where a mortgage on the real estate would be filed or recorded."⁹⁴ Certainly, the operator's security

87. U.C.C. § 9-402(5) (1978) [N.D. CENT. CODE § 41-09-41(5) (1983)].

88. See A.A.P.L. Form 610-1982 Model Form Operating Agreement. The cover page of the Model Agreement contains spaces for the names of the parties, a description of the contract area, and the date of the agreement. The practitioner should ensure that the model agreement contains all the information required by sections 9-402(1) and 9-402(5). The Code, however, provides that a financing statement should not be invalidated merely for "minor errors." See U.C.C. § 9-402(8) (1978) [N.D. CENT. CODE § 41-09-41(8) (1983)].

89. See, e.g., U.C.C. § 9-402(3) (1978) [N.D. CENT. CODE § 41-09-41(3) (1983)] (setting forth a sample financing form).

90. J. WHITE & R. SUMMERS, *supra* note 34, § 23-12, at 940; see U.C.C. § 9-401(1) (1978) [N.D. CENT. CODE § 41-09-40(1) (1983)].

91. See U.C.C. § 9-401(1) (1978). The three alternatives were proposed because of strong differences concerning the relative merits of local and statewide filing. See J. WHITE & R. SUMMERS, *supra* note 34, § 23-11, at 937. North Dakota adopted the second alternative. See N.D. CENT. CODE § 41-09-40(1) (1983).

92. See U.C.C. § 9-401 (1978).

93. See *id.*; see also J. WHITE & R. SUMMERS, *supra* note 34, § 23-13, at 943. The authors state that "the intrinsic nature of the goods does not classify them; rather it is the use to which the owner puts the goods, or intends to put them, that determines their classification." *Id.* (footnote omitted).

94. U.C.C. § 9-401(1) (1978) [N.D. CENT. CODE § 41-09-40(1) (1983)].

interest in the non-operator's share of extracted oil and gas constitutes an interest in oil and gas. Accordingly, the proper place to file the financing statement is the "office where a mortgage on the real estate would be filed or recorded."⁹⁵ In North Dakota, the proper place to record a real estate mortgage is with "the register of deeds of the county in which the real property affected thereby is situated."⁹⁶

As previously noted, an unperfected security interest is subordinate to the rights of a lien creditor.⁹⁷ After perfecting its interest in extracted oil and gas, however, the operator can defeat the subsequent claim of a lien creditor.⁹⁸ Additionally, subsection 9-312(5) provides that a perfected secured creditor has priority over other perfected security interests filed subsequent to his filing.⁹⁹ The preceding provisions indicate that the prudent operator should file and perfect his security interest as soon as possible. Finally, it should be noted that section 9-306 provides that a security interest in the extracted oil and gas continues even after

95. U.C.C. § 9-401(1) (1978) [N.D. CENT. CODE § 41-09-40(1) (1983)]. If the parties to the agreement are from different states that have adopted different alternatives to § 9-401(1), then § 9-103 provides that the law of the state wherein the wellhead is located governs. *See* U.C.C. § 9-103(5) (1978) [N.D. CENT. CODE § 41-09-03(5) (Supp. 1985)].

96. N.D. CENT. CODE § 47-19-07 (Supp. 1985).

97. *See supra* notes 72-73 and accompanying text.

98. *See* U.C.C. § 9-301(1) (1978) [N.D. CENT. CODE § 41-09-22(1) (1983)]. Subsection 9-301(1) of the UCC provides as follows:

Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of

- (a) persons entitled to priority under section 9-312;
- (b) a person who becomes a lien creditor before the security interest is perfected;
- (c) in the case of goods, instruments, documents, and chattel paper, a person who is not a secured party and who is a transferee in bulk or other buyer not in ordinary course of business or is a buyer of farm products in ordinary course of business, to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected;
- (d) in the case of accounts and general intangibles, a person who is not a secured party and who is a transferee to the extent that he gives value without knowledge of the security interest and before it is perfected.

U.C.C. § 9-301(1) (1978). In explaining the effect of § 9-301(1), White and Summers state that the section "provides in general that an unperfected secured creditor loses to a lien creditor and, by negative implication, that a perfected secured creditor beats a lien creditor." J. WHITE & R. SUMMERS, *supra* note 34, § 25-2, at 1031.

99. *See* U.C.C. § 9-312(5) (1978) [N.D. CENT. CODE § 41-09-33(5) (Supp. 1985)]. Subsection 9-312(5) of the UCC provides as follows:

In all cases not governed by other rules stated in this section . . . priority between conflicting security interests in the same collateral shall be determined according to the following rules:

- (a) Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.
- (b) So long as conflicting security interests are unperfected, the first to attach has priority.

U.C.C. § 9-312(5) (1978).

the collateral is sold and also continues in any identifiable proceeds of the sale.¹⁰⁰

B. PERFECTION OF THE SECURITY INTEREST IN EQUIPMENT

As indicated above, the equipment used to produce oil and gas constitutes "goods" within the meaning of Article 9.¹⁰¹ The method for perfecting a security interest in equipment would, therefore, be the same as the method used to perfect a security interest in the previously discussed goods — oil and gas that have been produced. Thus, an operator may perfect his security interest either by attaching and retaining possession, or by attaching and filing a financing statement.¹⁰²

However, the procedure required to perfect a security interest in equipment varies from that required to perfect a security interest in extracted oil and gas in one important aspect: if an operator seeks to perfect a security interest in equipment by filing a financing statement, it may be required to file that financing statement with the Secretary of State rather than filing locally.¹⁰³ The issue of where to file a financing statement covering equipment is complicated by the fact that some equipment constitutes pure equipment, while other equipment falls within the definition of fixtures.¹⁰⁴ To the extent that the equipment used to extract oil and gas constitutes pure equipment, it is not specifically addressed by section 9-401 of the UCC, and therefore must be filed in the office of the Secretary of State.¹⁰⁵ Once filed, the operator's perfected security interest would have the same priorities applicable to the perfected security in extracted oil and gas.¹⁰⁶

Some equipment used to produce oil and gas may be included

100. See U.C.C. § 9-306 (1978) [N.D. CENT. CODE § 41-09-27 (1983)]. Subsection 9-306(2) provides as follows: "Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collection received by the debtor." U.C.C. § 9-306(2) (1978).

101. See *supra* notes 28-29 and accompanying text.

102. See *supra* notes 75-100 and accompanying text.

103. See U.C.C. § 9-401(1) (1978) [N.D. CENT. CODE § 41-09-40(1) (1983)]. See generally B. CLARK, *supra* note 19, ¶ 13.4[1] (discussing problems in filing as it relates to security interests in equipment used to extract oil and gas).

104. See B. CLARK, *supra* note 19, ¶ 13.4. For a discussion of how the equipment used to extract oil and gas constitutes fixtures, see *infra* notes 107-19 and accompanying text.

105. See U.C.C. § 9-401(1)(c) (second alternative) (1978) [N.D. CENT. CODE § 41-09-40(1)(c) (1983)]. Subsection 9-401(1)(c) provides that if not explicitly addressed by § 9-401(1), then the proper place to file the financing statement is in the office of the Secretary of State. U.C.C. § 9-401(1)(c) (second alternative).

106. For a discussion of priorities in a perfected security interest in extracted oil and gas, see *supra* note 97-100 and accompanying text.

in a more limited category of goods known as fixtures.¹⁰⁷ Subsection 9-313(1)(a) of the UCC defines fixtures as goods that "become so related to particular real estate that an interest in them arises under real estate law."¹⁰⁸ It is a general principle of real estate law that a fixture is any item attached to land by roots, embedded in it, permanently resting upon it, or permanently attached to what is thus permanent.¹⁰⁹ Any piece of equipment that fits within this definition, then, would be classified as a fixture and could be perfected only by complying with the fixture filing provisions of Article 9.¹¹⁰

A financing statement covering fixtures, like those previously discussed covering extracted oil and gas, must comply with the general financing statement provisions of subsection 9-402(1) and with the additional provisions contained in subsection 9-402(5).¹¹¹ And, as previously discussed, the Model Agreement may be modified slightly to include the necessary information.¹¹² Form UCC-9-1, which identifies the machinery (pipe, valves, and other equipment), may be filed in addition to the Model Agreement to provide assurances that all the necessary information is present.¹¹³

Having determined that a security interest in fixtures requires the filing of a financing statement, and that the Model Agreement

107. See B. CLARK, *supra* note 19, ¶ 13.4. Clark states that numerous items used to extract oil and gas "may well constitute 'fixtures' under state law subject to a local 'fixture filing' and the priority rules of § 9-313 of the UCC." *Id.* ¶ 13.4, at 13-16.

108. See U.C.C. § 9-313(1)(a) (1978) [N.D. CENT. CODE § 41-09-34 (1983)].

109. See *Big Sespe Oil Co. v. Cochran*, 276 F. 216, 225 (9th Cir. 1921); see also *Hasse v. Dewitz*, 76 N.D. 108, 110, 33 N.W.2d 625, 626 (1948) (pursuant to North Dakota law a fixture is something attached to, imbedded in, or permanently resting upon a parcel of land); N.D. CENT. CODE § 47-01-05 (1983). Section 47-01-05 of the North Dakota Century Code provides the following definition of a fixture:

A thing is deemed to be affixed to land when it is attached to it by roots, as in the case of trees, vines, or shrubs, or imbedded in it, as in the case of walls, or permanently resting upon it, as in the case of buildings, or permanently attached to what is thus permanent, as by means of cement, plaster, nails, bolts, or screws.

Id.

110. See U.C.C. § 9-313 (1978) [N.D. CENT. CODE § 41-09-34 (1983)].

111. See U.C.C. § 9-313(1)(b) (1978) [N.D. CENT. CODE § 41-09-34(1)(b) (1983)]. Subsection 9-313(1)(b) provides the necessary elements of a fixture filing. See U.C.C. § 9-313(1)(b) (1978). The subsection provides as follows: "[A] 'fixture filing' is the filing in the office where a mortgage on the real estate would be filed or recorded of a financing statement covering goods which are or are to become fixtures and conforming to the requirements of subsection (5) of Section 9-402. . . ." *Id.* For a discussion of the requirements of § 9-402(1) and § 9-402(5), see *supra* notes 86-87 and accompanying text.

112. See *supra* notes 88-89 and accompanying text.

113. See 5A F. HART & W. WILLIER, *FORMS AND PROCEDURES UNDER THE UNIFORM COMMERCIAL CODE*, Form 9-1, at 9-88. The Code also provides that a mortgage is effective as a financing statement filed as a fixture filing provided: (1) the mortgage contains a description of the goods by item or type; (2) the goods are to become fixtures relating to the property described in the mortgage; (3) the mortgage meets the requirements of a financing statement; and (4) the mortgage is duly recorded. See U.C.C. § 9-402(6) (1978) [N.D. CENT. CODE § 41-09-41(6) (1983)].

may provide the necessary information to serve as a proper financing statement, it is necessary to determine the proper location for filing a financing statement covering fixtures. The question is resolved by section 9-401 of the UCC.¹¹⁴ Each of the three alternative versions of section 9-401 provides that "when the financing statement is filed as a fixture filing . . . [then the proper place to file is] in the office where a mortgage on the real estate would be filed or recorded."¹¹⁵ As previously stated, in North Dakota the proper place to file such an interest is with "the register of deeds of the county in which the real property affected thereby is situated."¹¹⁶

Finally, it is necessary to determine the operator's rights in his perfected security interest covering fixtures. As a holder of a perfected security interest, the operator would be entitled to the general priorities of subsection 9-312(5) of the UCC.¹¹⁷ However, the operator would be entitled to the additional protections of section 9-313 of the UCC.¹¹⁸ Subsection 9-313(4) provides that generally the holder of a perfected security interest in fixtures is entitled to priority against subsequent mortgagees, assignees, and grantees of the real estate to which the fixture is attached.¹¹⁹ Obviously, the prudent operator should make a fixture filing and thereby assure this added protection.

V. ENFORCEABILITY OF THE LIEN ON OIL AND GAS THAT ARE YET TO BE PRODUCED

The Model Agreement provides that the "Non-Operator grants to Operator a lien upon its oil and gas rights in the Contract

114. U.C.C. § 9-401 (1978) [N.D. CENT. CODE § 41-09-40 (1983)].

115. See U.C.C. § 9-401(1) (1978) (all three alternatives).

116. N.D. CENT. CODE § 47-19-07 (Supp. 1985).

117. For a discussion of the general rules of priority under § 9-312(5), see *supra* notes 97-100 and accompanying text.

118. See U.C.C. § 9-313 (1978) [N.D. CENT. CODE § 41-09-34 (1983)].

119. See U.C.C. § 9-313(4)(b) (1978) [N.D. CENT. CODE § 41-09-34(4)(b) (1983)]. Subsection 9-313(4)(b) of the UCC provides as follows:

A perfected security interest in fixtures has priority over the conflicting interest of an encumbrancer or owner of the real estate where . . . (b) the security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record, the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner, and the debtor has an interest of record in the real estate or is in possession of the real estate. . . .

U.C.C. § 9-313(4)(b) (1978). The general principle of § 9-313(4)(b) "is basically that a fixture filing gives to the fixture security interest priority as against other real estate interests according to the usual priority rule of conveyancing, that is, the first to file or record prevails." *Id.* § 9-313 official comment 4(b).

Area. . . ."¹²⁰ It has long been established, particularly in North Dakota and Montana, that such grants convey a mortgage interest in real property.¹²¹ Thus, Article 9 of the UCC will not apply to protect the interests of an operator in this item of collateral.¹²² An operator may, however, retain an enforceable interest in the oil and gas rights of a defaulting non-operator if it complies with the real estate recording statutes of the state where the property is located. In North Dakota, a mortgage instrument may be recorded if it contains "the post-office address of the mortgagee and an adequate statement as to the amount of indebtedness and the terms of interest."¹²³ North Dakota also requires acknowledgment of the interest as a prerequisite to recording.¹²⁴

The cover page of the Model Agreement contains a space for the date, identity of the operator, the contract area, and the county and state in which the contract area is located.¹²⁵ Yet, frequently the name of the operator is typed on the first page of the Model Agreement without the post office address of the mortgagee/operator. More importantly, the Model Agreement fails to sufficiently describe the contract area.¹²⁶ An accurate description of the contract area is necessary for proper indexing of the mortgage interest because an interest indexed under the wrong description in a courthouse tract may not give constructive notice to other creditors and mortgagees.¹²⁷ Both North Dakota and Montana set forth, by statute, examples of real estate mortgages.¹²⁸ An examination of various statutes in North Dakota and Montana

120. A.A.P.L. Form 610-1982 Model Form Operating Agreement, art. VII-B. For the relevant text of article VII-B, see *supra* text accompanying note 9.

121. See, e.g., *Gas Products Co. v. Rankin*, 63 Mont. 372, 392-93, 207 P. 993, 998 (1922) (petroleum and gas, as long as they remain underground, are a part of the realty); *Carlson v. Tioga Holding Co.*, 72 N.W.2d 236, 238 (N.D. 1955) (conveyance of interest in unextracted oil and gas was a conveyance in real property).

122. See U.C.C. § 9-104(j) (1978) [N.D. CENT. CODE § 41-09-04(10) (Supp. 1985)]. Subsection 9-104 provides, in pertinent part, as follows: "This Article does not apply . . . except to the extent that provision is made for fixtures in Section 9-313, to the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder. . . ." U.C.C. § 9-104(j) (1978).

123. N.D. CENT. CODE § 35-03-04 (Supp. 1985).

124. See *id.* § 47-19-03 (Supp. 1985).

125. See A.A.P.L. Form 610-1982 Model Form Operating Agreement.

126. See *id.* art. I-D. According to article I-D, the "'Contract Area' shall mean all of the lands, oil and gas leasehold interests and oil and gas interests intended to be developed and operated for oil and gas purposes under this agreement." *Id.* The Model Agreement does authorize, however, the attachment of an exhibit that more fully describes the contract area. See *id.*, art. I-D, art. II-A(1).

127. See *Hanson v. Zoller*, 187 N.W.2d 47 (N.D. 1971). In *Hanson* the North Dakota Supreme Court determined that there must be substantial compliance with the recording statutes for an instrument to give constructive notice to third persons. *Id.* at 56. The court held that an instrument not indexed under the correct tract description in the tract index does not constitute substantial compliance with the recording statutes. *Id.*; see also N.D. CENT. CODE § 35-03-07 (1980). Section 35-03-07 provides that "[t]he record of a mortgage duly made operates as notice to all subsequent purchasers and encumbrancers." *Id.*

128. See MONT. CODE ANN. § 71-1-204 (1985); N.D. CENT. CODE § 35-03-05 (1980).

reveals that a real estate mortgage could be created by adding the following language to the Model Agreement to identify the non-operator's indebtedness:

Each non-operator grants and mortgages to the operator all of its right, title and interest in and to all oil and gas rights in the contract area, including all of its oil, gas and other minerals in and under and to be produced from such area, and a security interest for its share of oil and /or gas when extracted and its interest in all equipment located within such area to secure payment of its share of expenses not to exceed \$_____, together with interest thereon at the rate provided for in Exhibit C.¹²⁹

Although this language may satisfy the requirements of the recording statutes, the language will generally be inadequate to cover the contingencies existing as a result of the unknown amount periodically due the operator to cover the costs of operations.¹³⁰ The operator must determine, and if possible, draft language to cover both the costs of the drilling and completion of the well and the monthly costs of operations. The Model Agreement provides that each party shall be liable "for its proportionate share of the costs of developing and operating the Contract Area."¹³¹ Therefore, when possible, provisions should be inserted into the Model Agreement so that it complies with state line of credit financing laws.¹³² Although the operator may be in possession of the property and thus many usual provisions of a mortgage are

129. *See, e.g.*, N.D. CENT. CODE § 35-03-01.1(1) (1980) (defining mortgage). According to § 35-03-01.1(1), a contract creates a mortgage when the contract hypothecates specific real property or an interest in real property to secure payment of a debt or obligation. *Id.*; *see also* MONT. CODE ANN. § 71-1-101 (1985) (similar definition of mortgage); *Bermes v. Sylling*, 179 Mont. 488, ___, 587 P.2d 377, 383 (1978) (a mortgage is every transfer of an interest in property made only as security for the performance of an act); *First Nat'l Bank v. Paulson*, 69 N.D. 512, 522, 288 N.W. 465, 471 (1939) (mortgage is a contract in which the mortgagor hypothecates the real property described in the contract for payment of the debt).

130. Both North Dakota and Montana limit by statute the security of a real estate mortgage to the specific amount stated in the mortgage. *See* MONT. CODE ANN. § 71-1-206(1) (1985); N.D. CENT. CODE §§ 35-03-04, -17 (Supp. 1985). Section 35-03-04 of the North Dakota Century Code provides that "[n]o mortgage of real property shall be received for record by the register of deeds unless it contains . . . an adequate statement as to the amount of indebtedness and the terms of interest." *Id.* § 35-03-04 (Supp. 1985). Subsection 71-1-206(1) of the Montana Code Annotated provides, in relevant part, as follows:

The total amount of indebtedness that may be secured by the mortgage may decrease or increase from time to time, but the total principal amount of the obligations secured at any one time may not exceed the face amount stated in the mortgage together with interest as provided in the instrument secured by the mortgage.

MONT. CODE ANN. § 71-1-206(1) (1985).

131. A. A. P. L. Form 610-1982 Model Form Operating Agreement, art. VII-A.

132. Section 35-03-17 of the North Dakota Century Code, for example, provides that a continuing lien on the property described, even though the indebtedness may be zero, can be

inapplicable, it may be advisable to include other provisions such as those providing identification for default, prohibiting encumbrance of the property, and providing for the payment of taxes.¹³³

The Model Agreement, in its present form as well as the form and manner generally completed, is unrecordable.¹³⁴ Even if it is made recordable, without other changes, its use as a valid real estate mortgage is suspect. Company policy may be such that the parties do not desire to record the Model Agreement.¹³⁵ Such a company decision simply ignores reality. The operator's failure to record the Model Agreement may result in the non-operating party mortgaging its interest elsewhere. In the event the non-operator defaults by nonpayment, a subsequent foreclosure of the mortgage could deprive the operator of any security or recourse in the collateral.

Treating the grant language of the Model Agreement as creating a mortgage interest could lead to additional and unforeseen problems. Recent authority in North Dakota could be interpreted to support the argument that when a creditor obtains a mortgage interest in real property, the only remedy a creditor has for nonpayment of the obligation secured by the mortgage is to foreclose the mortgage and obtain payment by sheriff's sale.¹³⁶ Arguably, the operator's taking of a mortgage interest could be seen as an election of remedies preventing the operator from

established by including the following language in the mortgage: "THE PARTIES AGREE THAT THIS MORTGAGE CONSTITUTES A COLLATERAL REAL ESTATE MORTGAGE PURSUANT TO NORTH DAKOTA CENTURY CODE CHAPTER 35-03." N.D. CENT. CODE § 35-03-17 (Supp. 1985) (emphasis in original). Section 35-03-17 also provides that such mortgages shall be entitled as follows: "MORTGAGE-COLLATERAL REAL ESTATE MORTGAGE." *Id.* (emphasis in original). According to § 35-03-17 "[c]ollateral real estate mortgages may be used to secure. . . lines of credit. . . . *Id.* Montana appears to limit the availability of a real estate mortgage to sums certain and to contemplated future advances. See MONT. CODE ANN. § 71-1-206 (1985).

133. See generally M. FRIEDMAN, CONTRACT AND CONVEYANCE OF REAL PROPERTY § 6.3 (4th ed. 1984) (discussing the general requirements of a mortgage).

134. Both North Dakota and Montana require that documents presented for recordation must be acknowledged. See MONT. CODE ANN. §§ 70-21-203, 71-1-207 (1985); N.D. CENT. CODE §§ 47-19-03, -04 (1978 & Supp. 1985). The Model Agreement, as presently drafted, does not contain a space for acknowledgment of the parties' signatures. See A.A.P.L. Form 610-1982 Model Form Operating Agreement. Additionally, both North Dakota and Montana require a description of the indebtedness secured as a condition to recording the mortgage. See MONT. CODE ANN. § 71-1-206(1) (1985); N.D. CENT. CODE § 35-03-04 (Supp. 1985). The Model Agreement generally does not meet this requirement. See A.A.P.L. Form 610-1982 Model Form Operating Agreement.

135. The author's personal correspondence with oil and gas executives indicates that many companies participating in oil and gas development feel there is no need to make the necessary changes to ensure that the Model Agreement complies with real estate mortgage law.

136. See *H & F Hogs v. Huwe*, 368 N.W.2d 553 (N.D. 1985). In *Hogs* the North Dakota Supreme Court held that a mortgagee could not forego its remedy of foreclosure under the mortgage and sue the mortgagor directly on the debt. *Id.* at 556. *But see* *Northern Trust Co. v. Buckeye Petroleum Co.*, No. 11,069, slip op. at 9 (N.D. June 19, 1986). In *Northern Trust* the North Dakota Supreme Court rejected the foregoing argument and concluded that a mortgagee holding both a security interest in extracted oil and gas and a mortgage interest in the property could enforce its security interest in extracted oil and gas without first having to foreclose its mortgage interest. *Id.*

proceeding against the personal property collateral.¹³⁷ However, it is the position of the author of this article that, in the event of default, the operator may proceed against the personal property collateral under the UCC, or may proceed against real property collateral under the state's real property laws.¹³⁸ Hence, the Model Agreement assignment of a security interest in extracted oil and gas and equipment should be enforceable against the non-operator without resorting to foreclosure of the mortgage.¹³⁹

VI. CONCLUSION

The drilling and completion of an oil and gas well is a high risk and expensive venture. The cost and risk associated with drilling and completion make it difficult for the operator to ensure adequate cash flow and protection of its investment. Many difficulties concerning the operator's security interest can be avoided if the parties carefully draft and prepare the Model Agreement. The drafters of the Model Agreement must comply not only with the Uniform Commercial Code, but also, because of the unique characteristics of oil and gas, with the real estate mortgage laws of the particular state where the drilling is to take place. The Model Agreement provides the legal means whereby a security interest under the provisions of the Uniform Commercial Code can attach and thereafter be perfected by proper filing procedures.

137. See *H & F Hogs v. Huwe*, 368 N.W.2d 553, 556. *But see* *Northern Trust Co. v. Buckeye Petroleum Co.*, No. 11,069, slip op. at 9. For a discussion of the *Hogs* and *Buckeye Petroleum* decisions, see *supra* note 136.

138. The author submits that the rule of *Hogs* — that a mortgagee can not forego its remedy of foreclosure under a mortgage and sue the mortgagor directly on the debt — is limited by the language of § 32-19-07 of the North Dakota Century Code to mortgages given “to secure the payment of money loaned upon real estate or to secure the purchase price of real estate.” N.D. CENT. CODE § 32-19-07 (1976); accord *Buckeye Petroleum*, No. 11,069, slip op. at 7 (restricting the *Hogs* rule to mortgages involving real property only). It is the author's position that the rule would not apply to a combination real estate mortgage and security agreement concerning personalty. See *id.* This is the type of financing arrangement that the author is familiar with in oil and gas financing and that the author urges parties to use in the Model Agreement. This position is consistent with § 9-501(4) of the UCC, which preserves the secured party's right to proceed against either the personal property or real property. See U.C.C. § 9-501(4) (1978) [N.D. CENT. CODE § 41-09-47 (1983)]. In *State Bank v. Hansen* the North Dakota Supreme Court construed § 41-09-47(4) of the North Dakota Century Code as follows:

We construe [section 41-09-47(4)] as providing a secured creditor, whose security encompasses both real and personal property, with the option of proceeding against all collateral in a single action providing that he does so in accordance with his rights and remedies accorded by the real property laws. However, we do not construe this subsection to prohibit a secured creditor from commencing separate actions to proceed independently against the personal property collateral and the real property collateral.

State Bank v. Hansen, 302 N.W.2d 760, 764 (N.D. 1981); see also *Buckeye Petroleum*, No. 11,069, slip op. at 7-8 (quoting and endorsing the preceding language from *State Bank v. Hansen*).

139. *Buckeye Petroleum*, No. 11,069, slip op. at 9.

Additionally, the Model Agreement may establish a mortgage interest in favor of the operator. Although the filing and perfection of those interests may require several different procedures, considering the current economic conditions the operator's efforts would be a prudent hedge against any insolvent non-operator.

