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OIL AND GAS FINANCING UNDER THE UNIFORM COMMERCIAL CODE AS ENACTED IN COLORADO

BY

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INTRODUCTION

Colorado has adopted the Uniform Commercial Code, effective July 1, 1966.[1] It is the purpose of this article to review briefly the mechanics of perfecting a security interest under the Code and to discuss in detail the application of specific Code provisions to oil and gas financing.[2] Particular emphasis will be placed upon filing and priority problems in Colorado.[3]

In general, Article 9 of the Code is intended to replace the various acts which previously regulated security interest in personal property.[4] In the interest of uniformity, Article 9 includes rules for the perfection of practically every type of consensual security interest in personal property but does not cover security interest in real estate,[5] except insofar as "fixtures" are involved.[6] This realty-personalty distinction is particularly crucial in oil and gas financing. If a security interest in real estate is involved, real estate recording laws are applicable. If a security interest in personal property is

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[1] Colo. Sess. Laws 1965, ch. 330; Vol. 7A, COLO. REV. STAT. (1963) ch. 155. For convenience, subsequent references will be made to Uniform Code sections only.

[2] Discussion of financing problems which may be unique to shale oil is beyond the scope of this article. For a general treatment of oil shale matters unrelated to finance see the Oil Shale Symposium 43 DEN. L.J. 1-90 (1966).

[3] For a general discussion of the Code as it relates to oil and gas financing, see Vagts, *The Impact of The Uniform Commercial Code on the Oil and Gas Mortgage,* 43 TEXAS L. REV. 825 (1965).

[4] General Chattel Mortgage Act [COLO. REV. STAT. §§ 21-1-1 to -20 (1963)]; Inventory Chattel Mortgage Statute [COLO. REV. STAT. §§ 21-2-1 to -13 (1963)]; Accounts Receivable Law [COLO. REV. STAT. §§ 11-2-1 to -9 (1963)].

[5] Section 9-104(j).

[6] Section 9-313.

involved, Article 9 of the Code is applicable and the Code "security agreement" and "financing statement" come into play.[7] If the collateral changes from realty to personalty, as may occur at the moment of extraction of oil and gas,[8] then both bodies of security law apply at different times. The realty-personalty distinction as it applies to oil and gas interests in Colorado is discussed in Part I of this article.

At this point, a brief review of the mechanics of Article 9 will provide a useful background for the discussion to follow. The key to Article 9 is "perfection"; that is, Article 9 is designed to regulate uniformly the perfection of various types of security interests in personalty as against third parties. Adoption of the Code eliminates existing inconsistencies arising from perfection of various security interests in the same collateral pursuant to separate statutory provisions. In general, Article 9 provides that a security interest is perfected when:

(a) there is an agreement that a security interest attach;[9] and

(b) value is given;[10] and

(c) the debtor has rights in the collateral;[11] and

(d) a financing statement is filed.[12]

Some exceptions are made for perfection by possession,[13] and certain types of purchase money security interests are exempted from the filing requirement.[14] The above rules of perfection are

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[7] Section 9-102(1)(a).

[8] Section 9-204(2)(b). See, *e.g.*, Kelly v. Ohio Oil Co., 57 Ohio St. 317, 49 N.E. 399 (1897).

[9] Section 9-204(1).

[10] *Id.*

[11] *Id.*

[12] Section 9-302(1). The contents of the financing statement are prescribed by § 9-402. It must give the addresses of the debtor and the secured party and must, with few exceptions, be signed by both parties. A copy of the security agreement may be filed as a financing statement if it contains the requisite information, but care should be taken to assure that the secured party has signed the instrument in addition to the debtor.

Special attention should be given to the provision of § 9-402(1), which requires that both parties "sign" a financing statement. A few liberal courts have held that the signature requirement was satisfied where a party "signed" in some manner other than manually. [See *In re* Horvath Bankruptcy No. 31477 (D. Conn. 1963) and Benedict v. Lebowitz, 346 F. 2d 120 (2d Cir. 1965) (typewritten signatures sufficient); *contra, In re* Kane, 55 Berks Co. L.J. (E.D. Pa. 1962) (photostatic copy of executed financing statement insufficient).] However, Colorado has added to that section a requirement that a financing statement be *manually* signed by the parties. Although this special provision clearly indicates that typewritten signatures or photostatic copies of executed financing statements will not suffice for filing in Colorado, the question remains whether a carbon copy of a manual signature will meet the statutory requirement. [See OP. ATT. GEN. OKLA., No. 63-299 (1963), 1 U.C.C. Rep. 790.]

[13] Section 9-305.

[14] Sections 9-302(1)(c) and (d).

generally applicable to oil and gas financing transactions, except as noted in specific instances in the text discussion which follows.

A financing statement may cover both the extracted hydrocarbons and the proceeds thereof.[15] It is only necessary that the financing statement designate that proceeds of the collateral are claimed. It should be noted that under Section 9-307(1) a purchaser of extracted hydrocarbons in the ordinary course of business will take free of a security interest in the hydrocarbons even though the purchaser knows of the existence of the security interest.[16] This provision is consistent with the need for marketability of the extracted hydrocarbons and does not adversely affect the secured party's interest in the proceeds of production.

Attention should also be given to Section 9-203(1)(b) which requires that a *security agreement* creating a security interest in oil or gas to be extracted include a description of the land concerned. Although no similar requirement is made as to a *financing statement* covering oil and gas to be extracted, it is suggested that the legal description of the land should also be included in the financing statement to satisfy Section 9-110, which requires reasonably accurate identification of the property covered by the statement.

As a practical matter, one of the primary advantages of code filing as to extracted hydrocarbons and proceeds is that it relieves the lender from dual filing under present chattel mortgage and accounts receivable statutes and greatly reduces periodic refiling presently required by those statutes. The five year initial filing period and five year continuation periods[17] will be much less burdensome to the lender than the considerably shorter initial filing periods and annual renewals presently required for chattel mortgages and assignments of accounts receivable in Colorado.[18]

The place for filing required by the Code is contingent upon classification of the collateral. Basically, all types of Code collateral involved in an oil and gas financing context would be goods[19] (which are further subclassified by Section 9-109 into four categories: con-

[15] Sections 9-306, 9-402(2)(b).

[16] Under the pre-Code Inventory Mortgage Act, a question existed whether extracted hydrocarbons awaiting sale and delivery in the ordinary course to a purchaser constituted "inventory." If they were considered "inventory," an opposite result would attach under the Act and a purchaser who had *actual* knowledge of the existence of a security interest could not take free of that interest. Since it is the intention of the parties that the security interest continue only in the proceeds of the sale of goods in the ordinary course of business, few lenders will mourn the repeal of this provision by enactment of the Code. See COLO. REV. STAT. § 21-2-7 (1963).

[17] Section 9-403(2)(3).

[18] COLO. REV. STAT. §§ 11-2-3 and 21-1-5 (1963).

[19] Section 9-105(f).

sumer goods, equipment, farm products, and inventory); accounts, contract rights or general intangibles;[20] and proceeds.[21] Various types of production machinery and equipment used in oil and gas operations may be classified as "equipment."[22] Extracted hydrocarbons awaiting delivery to a purchaser would probably be classified as "inventory."[23] The filing provisions adopted in Colorado provide for (i) local filing for consumer goods and farm interests, (ii) local filing for fixtures, and (iii) central filing for all other interests.[24] Thus, central filing in the office of the Secretary of State would be proper as to all oil and gas financing transactions involving personalty in Colorado, except where local filing may be necessary with respect to fixtures included in the mortgaged property. Certain filing problems pertaining to fixtures are discussed in Part IX of this article.

I. Oil and Gas Interests — Personal Property or Interests In Real Estate?

The vital question under the Code is whether various oil and gas interests — landowners' mineral and royalty interests, leasehold estates, overriding royalties, production payments and net profits interests — are personal property or interests in real estate. Section 9-104(j) provides that Article 9 does not apply "to the creation or transfer of an interest in or lien on real estate, including a lease." Presumably, this exclusionary rule is necessary to prevent conflict between the real estate recording laws and the filing provisions of the Code. Although direct case authority in Colorado is scanty, it may be generally concluded that all of the above-mentioned oil and gas interests, with the possible exception of the net profits interest, are "interests in real estate" for recording purposes and thus excluded from the filing provisions of Article 9.

The Colorado Supreme Court has stated that the landowner's mineral estate is "an interest in the real property"[25] and that his royalty interest under a lease is "born of and is a part of the land itself."[26] Although there are no Colorado decisions which expressly classify

[20] Section 9-106.

[21] Section 9-306.

[22] Section 9-109(2).

[23] Section 9-109(4).

[24] Sections 9-401(1)(a), (b), and (c).

[25] Simson v. Langholf, 133 Colo. 208, 217, 293 P.2d 302, 307 (1956). See also, Moshiek v. Lininger, 130 Colo. 266, 274 P.2d 965 (1954).

[26] Cruse v. Marston, 112 Colo. 291, 294, 148 P.2d 1004, 1006 (1944) (royalty income to Colorado resident from Texas oil lands held to be derived from *tangible* property within the meaning of a surtax provision of the Colorado income tax law).

the *lessee's* interest and interests created from it, the majority rule,[27] and the general opinion of the Colorado Bar, is that such are "interests in real estate"[28] for mortgage recording purposes.[29]

An argument to exclude oil and gas leasehold interests from the operation of the Code may be derived from the portion of Section 9-104(j) which speaks of "real estate, including a lease." One construction of this provision is that "lease" includes a mineral lease, and that an oil and gas leasehold is an interest in real estate for Code purposes regardless of its characterization under prior state law. If this construction is sound, it follows that the Code expressly overrides any state law which suggests that a leasehold interest may be something other than realty. This interpretation, however, overlooks the underlying policy of Section 9-104 (j), which is to defer to state law for a determination between interests in realty and personalty. The preferable construction, therefore, is that a lease is excluded from the rules of Article 9 only if it constitutes, under state decisional law, "an interest in real estate."

A more persuasive argument to exclude oil and gas leaseholds

[27] Representative jurisdictions applying the majority rule are Oklahoma [Continental Supply Co. v. Marshall, 152 F.2d 300 (10th Cir. 1945), *cert. denied,* 327 U.S. 803 (1946)]; Texas [Carroll v. Holliman, 336 F.2d 425 (10th Cir. 1964)]; and California [Callahan v. Martin, 3 Cal. 2d 110, 43 P.2d 788 (1935)].

In New York, an oil and gas leasehold and interests carved out of it constitute personalty, by statute. N.Y., General Construction Law, § 39; Wagner v. Mallory, 169 N.Y. 501, 62 N.E. 584 (1902).

Kansas appears to be the only state which holds, in the absence of a clear statutory provision, that an oil and gas leasehold is personalty for recording purposes. Shields v. Fink, 190 Kan. 17, 372 P.2d 252 (1962). Kansas has enacted the Code effective January 1, 1966. Thus, a Colorado bank financing development of a Kansas lease must file under the Code as to the leasehold itself. Real estate recording would provide additional protection in Kansas. See KAN. STAT. ANNO. 58-2221 (1963).

[28] Use of the phrase "interest in real estate" may lead to confusion in interpretation of § 9-104(j). This confusion stems from the fact that according to traditional property law *interests in land* may be classified as either personal property or real property. All interests in land of lesser dignity than a freehold estate, such as a term for years, are traditionally regarded as chattels real; that is, personal property interests in land. POWELL, REAL PROPERTY, § 98 (1949). Thus, a question is presented whether the Code draftsmen intended by § 9-104(j) to exclude from operation of Article 9 all interests in real estate, whether traditionally regarded as realty or personalty. This formalistic distinction is particularly important in states such as Colorado, which have not yet ruled that the lessee obtains ownership of the oil and gas in place. *Contra,* see Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923). If the language of § 9-104(j) is literally interpreted, there is no question that an oil and gas leasehold estate and other interests created from it are interests in real estate excluded from the operation of Article 9, since that section does not differentiate as to chattels real. For a general discussion of the realty-personalty classification of interests in land see 1 WILLIAMS & MEYER., OIL AND GAS LAW, § 212 (1964). Moreover, in Radke v. Union Pac. R.R., 138 Colo. 189, 207, 334 P.2d 1077, 1087 (1959) the court, in construing an ambiguous mineral reservation in a deed as a "license," added by way of dictum: "Under a lease *an interest—or estate—in the land* itself is created, which is not true of a mere license." (Emphasis added.)

[29] There is no question that an oil and gas lease is an instrument affecting the title to real property, subject to the Colorado real estate recording statute. COLO. REV. STAT. § 118-6-9 (1963). See Brice v. Pugh, 143 Colo. 508, 354 P.2d 1024 (1960). It seems logical that an instrument creating a security interest in an oil and gas lease would be similarly treated.

from operation of the Code can be fashioned from Section 9-204(2)(b), which provides that "the debtor has no rights . . . in oil, gas, or minerals until they are extracted." This provision seems clearly intended to keep under the real estate recording laws any type of security interest relating to *unextracted* hydrocarbons.

The weight of authority in other jurisdictions and the treatment of a landowner's interest in unextracted oil and gas as realty in Colorado, lead to the conclusion that an oil and gas leasehold estate and the interests created from it constitute "interests in real estate" within the meaning of Section 9-104(j).[30]

Assuming that the oil and gas leasehold is "an interest in real estate" exempted from Code filing, it would seem to follow that other interests created from the leasehold estate, such as overriding royalty interests and production payments, are similarly exempted. The one interest, however, which may partake more of the qualities of personalty, is the "net profits interest."[31] There is some indication from the cases, at least by way of dictum, that a net profits interest is a mere contract light.[32] Under such a classification, a mortgage of a

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[30] There is authority in Colorado that an oil and gas lessee does not obtain a "vested" property interest in the hydrocarbons in place until hydrocarbons are produced from the leasehold in paying quantities. In other words, the lessee's interest in Colorado may be "inchoate" until the hydrocarbons are discovered on the leasehold in paying quantities. See generally, March, *The Interest of Landowner and Lessee in Oil and Gas in Colorado,* 25 ROCKY MT. L. REV. 117 (1953). Several older Colorado decisions hold that long-term, or "no term" leases with delay rental provisions, may be terminable by the lessor if the lessee fails to develop the premises for oil and gas within a certain period of time. Florence Oil & Ref. Co. v. Orman, 19 Colo. App. 79, 73 Pac. 628 (1903); Lanham v. Jones, 84 Colo. 129, 268 Pac. 521 (1928). These authorities suggest that the lessee has an interest in the nature of a revocable license rather than a vested property interest in the unextracted minerals. The general rule, by contrast, seems to be that a lessee's interest is fully vested upon execution of the lease. See, *e.g.,* Rich v. Doneghey, 71 Okla. 204, 177 Pac. 86 (1918). Where the parties expressly contract for payment of delay rentals to perpetuate the leasehold estate during the primary term prior to drilling or production, the lessor does not, of course, have the right to revoke the lease if rentals have been timely paid. Although the Colorado Supreme Court has not yet passed on the nature of the lessee's interest under a modern "unless" form of oil and gas lease, it is possible that prior authority will lead the court to perpetuate the "revocable license doctrine," which conditions vested ownership in the lessee upon a discovery of hydrocarbons in paying quantities.

However, none of these older Colorado cases suggests that the lessee's interest, whether or not inchoate prior to discovery, is not "an interest in real estate." Therefore, they should not alter the conclusion that the real estate recording laws are applicable to a mortgage of an oil and gas leasehold interest, and that the filing rules of Article 9 are applicable only as to extracted hydrcarbons. But, see Hoagland, *A Form of Mortgage and Assignment of Oil and Gas Production,* 34 DICTA 226 (1957), where it is stated that Colorado is "in mid-air" as to whether a lessee's interest and related interests are "interests in land."

[31] The net profits interest is a share of gross production from a producing property, measured by the net profits from operation of the property. See 2 WILLIAMS & MEYERS, OIL AND GAS LAW, § 424.1 (1964).

[32] In LeBus v. LeBus, 269 S.W.2d 506 (Tex. Civ. App. 1954), there was an alleged oral agreement that, in consideration for services in acquiring a leasehold for X, Y would be entitled to one-fourth of the net profits, if any, resulting from operation of the lease. The court stated that this transaction created a mere contractual right to have a share of the profits paid over when earned—"a profit-sharing agreement"—rather than a vested partnership interest in the realty. *Contra,* Greenleaf v. S. A. Camp Ginning Co., 150 Cal. App. 385, 309 P.2d 943 (1957).

net profits interest would presumably constitute a security interest in a "contract right" within the meaning of Section 9-106, and Code filing would be necessary to protect the mortgagee.[33] Despite the contractual quality of the net profits interest, it is submitted that it should also be treated as an "interest in real estate" for purposes of the recording statutes.[34] However, for complete protection, real estate recording *and* Code filing should be accomplished where a net profits interest is included as part of the collateral.[35]

This article will proceed on the assumption that an oil and gas leasehold estate and other interests fashioned from it are "interests in real estate" and are not subject to the filing requirements of Article 9.

Despite the classification difficulties as to interests in unextracted hydrocarbons, it is clear under the Code that the extracted hydrocarbons become personalty subject to the rules of Article 9.[36] In addition, the general rules of Article 9 are applicable to the various types of equipment and machinery used in oil and gas operations, insofar as such machinery and equipment remain personalty under the decisional law of Colorado. If goods become fixtures, Section 9-313 provides special rules for ascertaining the priority of conflicting security interests in the fixtures and the real estate.

In many respects, financing of the oil and gas industry involves considerations common to other industries. For example, the use of after acquired property clauses and future advance provisions is as commonplace in the oil and gas mortgage as in the mortgage of an automobile dealer's inventory.[37] However, the types of collateral covered by an oil and gas mortgage may present special problems under Article 9 which are not usually encountered in other areas of finance. Although implimentation of the Code will eliminate certain inconsistencies in present law, the broad base of Article 9 will inevitably provide a breeding ground for new problems to replace

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[33] Section 9-103 provides that filing as to contract rights must be made in the state where the assignor keeps his records concerning them.

[34] For a strong opinion to this effect, see 2 WILLIAMS & MEYERS, *op. cit. supra* note 31, § 424.1.

[35] Careful draftsmanship may also help to detract from the contract right theory. A net profits interest created and conveyed as *an interest in real estate measured by profits derived from operation of the property* would be less susceptible to interpretation as a mere contractual interest.

[36] Section 9-204(2)(b). See also, 1 WILLIAMS & MEYERS, *op. cit. supra* note 31, § 212.

[37] See generally, Voorhees, *Financing Oil and Gas Operations on Credit—Mortgages and Liens,* FIFTH ANNUAL ROCKY MOUNTAIN MINERAL LAW INSTITUTE 365 (1960); Johnson, *Legal Aspects of Oil and Gas Financing,* NINTH ANNUAL INSTITUTE OF OIL AND GAS LAW AND TAXATION 141 (1958).

the old. The remainder of this article will explore some of these problem areas unique to oil and gas financing under the Code.[38]

II. FEDERAL OIL AND GAS LEASES

Personal property security interests in federal oil and gas leases seem at first glance to present a special problem. Section 9-302(3) states that "The filing provisions [of Article 9] do not apply to a security interest in property subject to a statute . . . (a) of the United States which *provides for* . . . filing of all security interests in such property." (Emphasis added.) Under the Mineral Leasing Act of 1920[39] and the regulations issued pursuant thereto, it is provided that:

> Except for assignments of royalty interests all instruments of transfer of a lease or of an interest therein . . . must be filled for approval within 90 days from the date of final execution . . . .[40]

Although the regulation appears to be phrased broadly enough

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[38] The most immediate practical problem for oil and gas financers, as well as for other lenders, will be the problem of transition to the new law when it becomes effective July 1, 1966. Oil and gas financing arrangements are usually long-term affairs involving after-acquired property, future advances and renewal filings. What happens to pre-Code loans when the new law comes into effect? Must lenders file anew when the Code becomes law? May pre-Code transactions be brought under the Code if the parties desire to do so? Where are post-Code renewal filings made? Will refiling under the Code bring with it all the substantive law of Article 9, which is generally more advantageous to the lender than the old law?

Section 10-101 of the Code attempts to answer these questions by providing that:

> Transactions validly entered into prior to the effective date . . . and the rights, duties, and interests flowing from them remain valid thereafter and may be terminated, completed, consummated, or enforced as required or permitted [by prior law].

Although this provision presents problems too numerous for discussion in this article, the following may be stated as a series of general conclusions: a bank financing a pre-Code oil and gas loan may keep the old filings alive and file status statements under the pre-Code statutes, even after the Code becomes effective. The substantive law of the repealed statutes will in every way continue to control pre-Code loans until a new, post-Code "transaction" is created by reexecution of the instrument securing the loan, or until the parties enter a choice-of-law contract binding them to the substantive law of the Code and to its filing requirements. See Clark, *U.C.C. Articles 9 and 10: Some Problems Solved and Some Problems Created,* 38 U. COLO. L. REV. 99 (1965). For difficulties raised in connection with transition to the Code in other states, see Janover and Dulles, *The Application of the Transistion Provisions of Uniform Commercial Code Article 10 to Chattel Security Filing,* 39 N.Y.U.L. REV. 1027 (1964); Auerbach & Goldston, *Variations in the Ohio Enactment of the Uniform Commercial Code,* 14 W. RES. L. REV. 22, 51 (1962).

[39] 41 Stat. 437 (1920); *as amended,* 30 U.S.C. § 181-94 (1964).

[40] 43 C.F.R. § 3128.2(a)(1) (1965). In addition, certain procedural benefits are derived from filing a mortgage in the Land Office. 43 C.F.R. § 1840.0-6(d) (1965) and 43 C.F.R. § 1850.0-6(d) (1965) provide:

> Transferees and encumbrancers of land, the title to which is claimed or is in the process of acquisition under any public land law shall, upon filing notice of the transfer or encumbrance in the proper land office, become entitled to receive and be given the same notice of any contest, appeal, or other proceeding thereafter initiated affecting such interest which is required to be given to a party to the proceeding. Every such notice of a transfer or encumbrance will be noted upon the records of the land office. Thereafter such transferee or encumbrancer must be made a party to any proceedings thereafter initiated adverse to the entry.

to include mortgages within its terms, a memorandum[41] from regional counsel of the Department of the Interior has implied that approval of a mortgage of a federal lease is not required. Thus, mortgages are commonly accepted by Land Offices for filing in the case files without the necessity of approval. This, in turn, raises a question whether the Mineral Leasing Act "provides for . . . filing of all security interests" in federal oil and gas leases and thereby excludes filing under Article 9.

Although parties who search the Land Office records may obtain actual notice of instruments on file, a troublesome question exists whether the records are also sufficient to impart constructive notice. With this problem in mind, most attorneys advise that a mortgage of an interest in a federal lease be recorded in the county, as well as filed in the Land Office. Such dual filing protects the mortgagee from the uncertainties which stem from the fact that the Mineral Leasing Act is not a federal recording statute. Failure to record in the county has in some cases led to loss of priority as against subsequent purchasers of an interest in the federal lease.[42] However, the opposite result has also been reached by theory of "implied actual notice" or "judicial notice."[43]

The answer to this problem may be found, in part, in the Official Comment to Section 9-302(3), which refers to specific federal recording statutes which preempt the field, as for mortgages on aircraft[44] or railroads.[45] At present, the Mineral Leasing Act and regulations lack the specificity of the federal recording statutes cited in the Official Comment. Thus, it is likely that filing under Article 9 will be required, in addition to Land Office filing, where chattel security interests in federal oil and gas leases are involved. In light of the more recent cases dealing with the Land Office record notice problem,[46] the prudent lender would be well advised to accomplish dual filing until the problem is resolved by legislative action. However, if a mandatory federal recording statute is added to the Mineral

[41] Memorandum to Regional Administrator, Region VI, GS-BLM-1953-100 (July 14, 1953).

[42] Bolack v. Underwood, 340 F.2d 816 (10th Cir 1965); Torgeson v. Connelly, 348 P.2d 63 (Wyo. 1959); Dame v. Mileski, 80 Wyo. 156, 340 P.2d 205 (1959).

[43] Krueger v. United States, 246 U.S. 69 (1918); Brush v. Ware, 40 U.S. (15 Peters) 93 (1841); South v. Wishard, 146 Cal. App. 2d 276, 303 P.2d 805 (1956); Arnold v. Universal Oil Land Co., 45 Cal. App. 2d 522, 114 P.2d 408 (1941); Livermore v. Beal, 18 Cal. App. 2d 535, 64 P.2d 987, *cert. denied,* 302 U.S. 712 (1937); Gabbs Exploration Co., 67 Interior Dec. 160 (1960); James C. Forsling, 56 Interior Dec. 281 (1938).

[44] 63 Stat. 940 (1949), 49 U.S.C. § 1403 (1964).

[45] 66 Stat. 724 (1952), 49 U.S.C. § 20(c) (1964).

[46] See cases cited note 42 *supra.*

Leasing Act,[47] the Code would become clearly inapplicable to perfection of security interests in federal oil and gas leases.[48]

III. GENERAL PROVISIONS

One of the more important changes which will occur upon implimentation of the Code in Colorado pertains to a mortgage by a corporate debtor which covers both realty and personalty. Such a "mixed mortgage" is commonplace in oil and gas financing. The General Chattel Mortgage Act presently provides that if the mixed mortgage is recorded in the real estate records of the appropriate county, it shall also be a lien against the mortgaged personalty without the necessity of complying with the filing provisions of the General Chattel Mortgage Act.[49] It could be argued that filing would nevertheless be required as to inventory and accounts receivable, which are generally controlled by the Inventory Chattel Mortgage Statute and Accounts Receivable Law, rather than the General Chattel Mortgage Statute. However, there is some authority for the proposition that failure to comply with the applicable filing provisions of the Inventory Mortgage Act and Accounts Receivable Law will bring the transaction within the provisions of the General Chattel Mortgage Act.[50] Thus, under pre-Code law the lender could be reasonably certain that a single recording pursuant to the General Chattel Mortgage Act would suffice to cover both the realty and the personalty of the corporate mortgagor. Enactment of the Code in Colorado will upset this simplified scheme of perfection and require Code filing in addition to real estate recording.

With respect to proceeds arising from the sale of extracted

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[47] Such an amendment to the Mineral Leasing Act was recently advocated by Senator Gordon Allott in an address before the Association of American Petroleum Landmen on June 25, 1965.

[48] Analogous problems concern security interests in oil and gas leases issued by the State of Colorado. Section 9-302(3)(b) exempts from the filing provisions of Article 9 security interests in property subject to a statute "[o]f this state which *provides for* central filing of security interests in such property. . . ." (Emphasis added.) Although COLO. REV. STAT. § 112-3-10 (1963) provides that the records "kept by the state board of land commissioners shall be a part of the public records of said board and shall be open to inspection," this section does not purport to be a recording statute.

[49] COLO. REV. STAT. § 21-1-9 (1963). An interesting question is presented as to whether this statute is intended to relieve the mortgagee from filing as a chattel mortgage with respect to personalty kept in counties other than the county where the mortgaged real estate is situated. *Cf.* COLO. REV. STAT. § 21-1-4(2) (1963). This uncertainty will be mooted by enactment of the Code.

[50] Exchange Nat'l Bank v. Hough, 258 F.2d 785 (10th Cir. 1958). The *Hough* case, however, also suggests that compliance with the more stringent requirements of the General Act, such as direct application of the proceeds to the mortgage indebtedness, would be necessary if the Inventory Mortgage Act and Accounts Receivable Law were not complied with. *Id.* at 789-90.

hydrocarbons, Section 9-306(3) provides in effect that a perfected security interest in hydrocarbons will be automatically perfected in the proceeds thereof for ten days after the debtor receives the proceeds. The security interest will be continuously perfected if the financing statement on file states that it covers proceeds or if a financing statement covering proceeds is filed before expiration of the ten day period. This ten day "grace period" for perfection has no counterpart under the present Accounts Receivable Law. Moreover, a security interest in proceeds, whether perfected initially or during the ten day period, will be continuously perfected against third parties, including a trustee in bankruptcy or a levying creditor, as to accounts and cash proceeds identified according to the tracing rules of Section 9-306(4).

A more subtle problem may be encountered under Code law concerning express subordination agreements. The Code authorizes "subordination by agreement by any person entitled to priority."[51] Contractual subordination of competing security interests has been, and will continue to be, an important tool in oil and gas financing. As has sometimes been the practice, subordination agreements have not been placed of record. However, under the Code a serious question exists whether a subordination agreement constitutes a "security interest" and is subject to the filing rules of Article 9.[52] Until this question is resolved, parties to a subordination agreement would be well advised to file under the Code if practicable.

IV. Equipment and Motor Vehicles

"Equipment" is defined in Section 9-109(2) as goods used or bought for use in business. Rigs, pumps, drilling apparatus and other machinery used upon the oil and gas leasehold would presumably fall under this definition.[53] Often equipment used in leasehold operations is motorized or attached to motor vehicles. For example, some types of modern drilling rigs are self-propelled vehicles. The Code,[54] read in connection with the Colorado Certificate of Title

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[51] Section 9-316.

[52] See Zinman, *Under the Spreading U.C.C.—Subordinations and Article 9*, 7 B.C. Ind. & Comm. L. Rev. 1 (1965). Coogan, Kripke and Weiss, *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 Harv. L. Rev. 229 (1965).

[53] "Consumer goods" are defined in § 9-109(1) as goods "used or bought for use primarily for personal, family, or household purposes." Because oil and gas equipment does not ordinarily constitute consumer goods, there need be no itemization of the equipment to make the description sufficient in the financing statement, as is otherwise required by § 9-110.

[54] Sections 9-302(3)(b) and (4).

Act,[55] provides that Article 9 does not cover the perfection of security interests in "motor vehicles." Section 9-302(4) states:

> The filing provisions of this article do not apply to a security interest in property subject to a statute . . . [o]f this State which provides for a central filing of security interests in . . . a motor vehicle which is not inventory held for sale for which a certificate of title is required under the statutes of this state, if a notation of such security interest can be indicated by a public official on a certificate or duplicate thereof . . . . A security interest in property covered by a statute described in subsection (3) of this section *can be perfected only by . . . indication of the security interest on a certificate of title* . . . . (Emphasis added.)

The Certificate of Title Act fits squarely into this Code scheme by providing, in section 13-6-19, that chattel mortgage filing "shall not . . . apply to the mortgaging of motor vehicles." Section 13-6-19 requires that an encumbrance upon a motor vehicle, to be valid against third parties, "shall be filed for public record and the fact thereof noted on the owner's certificate of title . . . ." In other words, where oil and gas equipment includes "motor vehicles," Article 9 filing is inadequate; only certificate of title notation protects the lien. In all other respect (*i.e.,* rights on default, priorities, etc.), Article 9 still applies.[56]

Although it seems clear that a self propelled drilling rig would be a "motor vehicle," questions may arise whether other types of oil and gas equipment attached to a motor vehicle become part of the vehicle for filing purposes. The Certificate of Title Act is not helpful in its definition of motor vehicle as "all vehicles propelled by power, other than muscle power . . . ."[57] However, the Colorado Supreme Court has ruled that a purchase money security interest in tires affixed to a motor vehicle is not subordinate to a prior mortgage with an after-acquired property clause which encumbers the vehicle. The court reasoned that the tires were subsequently added to the vehicle as an accessory, were readily detachable, and thus were not "merged" into the "motor vehicle."[58] The same rationale could apply to oil and gas equipment subsequently attached to a motor vehicle covered by a prior mortgage. If, however, equipment were attached to a vehicle *prior to* execution of a security agreement covering the equipment, a court might conclude that the equipment had become part of the "motor vehicle" and subject to the Certificate of Title

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[55] COLO. REV. STAT. §§ 13-6-1 to -43 (1963). The statute excludes from the definition of motor vehicle "industrial machinery not designed primarily for highway transportation." This exclusion is not, however, helpful with respect to equipment attached to motor vehicles which are subject to the Certificate of Title Act.

[56] See Kapral v. Hanover Nat'l Bank, 52 Luz. Leg. Reg. 276 (Ct. C. P., Pa., 1962).

[57] COLO. REV. STAT. § 13-6-2(2) (1963).

[58] Rabtoay Gen. Tire Co. v. Colorado Kenworth Corp., 135 Colo. 110, 120, 309 P.2d 616, 621 (1957).

Act. If so, a security interest in the equipment could only be perfected by compliance with the Certificate of Title Act, and Article 9 would be inapplicable. Where this uncertainty is present the oil and gas mortgagee should obtain complete protection by filing under the Code as to all "equipment" *and* complying with the Certificate of Title Act as to any equipment which is motorized or attached to motor vehicles.[59]

V. ACCOUNTS, CONTRACTS RIGHTS AND GENERAL INTANGIBLES

The Code's definitions of accounts, contract rights and general intangibles bear careful consideration in the oil and gas context. Section 9-106 states:

> "Account" means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper. "Contract right" means any rights to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper. "General intangibles" means any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents, and instruments.

Section 9-103, dealing with conflict of laws, provides that filing as to *accounts or contract rights* is governed by the law of the state in which the assignor has located *the office which keeps the records* concerning such accounts or contract rights.[60] On the other hand, filing as to *general intangibles* is governed by the law of the state where the *debtor's chief place of business* is located.[61] Because of this filing distinction, it is vital that the nature of the collateral be accurately analyzed in each financing transaction to assure that an effectual Code filing in the proper state will be accomplished.

Where a filing is made as to accounts or contract rights, the law (including the conflict of laws rules) of the state where the assignor's records are kept will control. Section 9-103 is, of course, the relevant conflict of laws rule for all states which have adopted the Code. However, if the assignor's records are kept in a non-Code state, such as Delaware, complications will arise. The conflict of laws rule of the non-Code state may require that the assignee file in the state where

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[59] Another problem arises with respect to oil and gas equipment moved from state to state. In such cases (assuming that all states involved have adopted the Code), filing in the first state will be effective in the second state for four months after the equipment is moved to the second state. Section 9-103(3). If filing is accomplished in the second state within the four month period, perfection of the security interest relates back to the first filing; if filing in the second state is accomplished after the four month period, perfection dates from filing in the second state. Where oil and gas equipment is transported across state lines, the lender should, therefore, file timely financing statements in the adjoining state, as well as in Colorado.

[60] Section 9-103(1). The Code gives no definition of "records."

[61] Section 9-103(2). The term "debtor," as used in § 9-103(2), means the owner of the collateral subject to the security interest and should not be confused with the term "account debtor." See §§ 9-105(a) and (d).

the oil is produced or where the records of the oil purchaser are kept. Thus, troublesome multiple filings may be necessary in one or more states unrelated to the loan transaction.

Another problem may arise where oil and gas in place is committed to a purchase contract prior to extraction. This will nearly always be the case where production of natural gas is involved. In such a case, the lender may never have acquired a security interest in severed hydrocarbons; instead, the lender's security interest intitally may have attached to "contract rights" which ripened into "accounts" upon delivery of the extracted hydrocarbons to the production purchaser at the wellhead. In this respect the contract rights, *as independent collateral,* may be subject to the special filing provisions of Section 9-103, instead of the filing provisions of Sections 9-401 and 9-306, which apply to contracts rights *as mere proceeds* of the extracted hydrocarbons.[62] Thus, if the record keeping office of the debtor is located outside of Colorado, it is advisable for the lender to file in both states.

An anomalous situation may also result from the Code distinction between "contract right" and "general intangible." A purchase contract, viewed from the seller's standpoint, creates a right to receive payment for hydrocarbon substances delivered to the purchaser. This is a "contract right" which matures into an "account" upon performance by the seller.[63] But from the purchaser's standjoint the contract creates a right to receive goods and is therefore classified as a "general intangible."[64] Where a financing transaction involves a pipeline or processing company as a debtor this distinction is vital. It is common practice in such situations to include as part of the

[62] If the contract rights or accounts were construed as mere "proceeds" of the hydrocarbons, the proper place of filing would be with the Colorado Secretary of State, because the primary collateral is the "goods." Section 9-306(2).

Another problem concerning proceeds, accounts and contract rights may arise under § 9-306(3), which provides that a security interest in proceeds relates back to the time of perfection of the security interest in the collateral which gave rise to the proceeds. This provision was intended, among other things, to alleviate any question of voidable preference in bankruptcy where the proceeds were obtained within the four month period but the security interest in the collateral was perfected prior thereto. Unfortunately, this provision may confuse the priority of competing security interests in contract rights, accounts and proceeds. Where hydrocarbons in place are covered by a purchase contract prior to extraction, as in the case of a gas purchase contract, the collateral may never take the form of "goods" (extracted hydrocarbons). Instead, the collateral may constitute "contract rights" (before extraction) and "accounts" (after extraction). If Lender A files as to extracted hydrocarbons, accounts and proceeds, and Lender B subsequently files as to contract rights, accounts and proceeds, which party has priority as to proceeds? Lender B may argue that his perfected interest in proceeds relates back to his perfected interest in contract rights under § 9-106, which indicates that a contract right necessarily exists prior to the account which arises from performance of the contract. To avoid any such controversy, Lender A should have filed as to contract rights as well as extracted hydrocarbons, accounts and proceeds.

[63] Section 9-106 provides that a "contract right" is limited to rights to "payment."

[64] Section 9-106.

mortgaged property all of the debtor's purchase and sales contracts in addition to the physical assets. If the record keeping office and chief place of business of the debtor are in different states, care must be taken to comply with the filing laws of the applicable jurisdictions.

Moreover, the lender's problem is unfortunately accentuated by the Code's use of the phrase "chief place of business." The great body of case law dealing with this legal concept has not resolved it to the satisfaction of the security needs of the lender. Indeed, multiple filings as to general intangibles may be necessary to cover adequately all jurisdictions in which the debtor conducts business, at least when the debtor's business activities are substantial enough to raise a question that any one or more of such states may be deemed to be his "chief place of business."[65]

VI. VOIDABLE PREFERENCE

An important question may arise under bankruptcy law as to whether extracted hydrocarbons applied toward satisfaction of mortgage indebtedness constitute a transfer to the creditor on account of an antecedent indebtedness within the "voidable preference" section of the Bankruptcy Act.[66] The problem stems from Code provisions related to perfection of security interests in after-acquired property. A security interest cannot attach until the debtor has rights in the collateral, and the Code specifically provides that the debtor has no rights in oil and gas until they are extracted.[67] Because one of the requirements for perfection of a security interest is that it must attach to the collateral, it follows that the lender's security interest is extracted hydrocarbons can never be perfected under the Code prior to the moment of extraction. Although a financing statement covering proceeds of production may be filed prior to development of the leasehold, the lender nevertheless faces attack by the trustee in bankruptcy as to the proceeds attributable to each unit of oil and gas extracted within four months of the filing of the petition in bankruptcy. Provided that all other elements of a voidable preference are present, the trustee in bankruptcy may assert that delayed perfection rendered the transaction a transfer to secure an antecedent debt.

Section 9-108 of the Code anticipates this problem and provides that the lender's "security interest in the after-acquired collateral

[65] For a general discussion of problems of terminology involved in choosing where to file under the Code, see Coogan and Gordon, *The Effect of the Uniform Commercial Code Upon Receivables Financing—Some Answers and Some Unresolved Problems*, 76 HARV. L. REV. 1529, 1539 (1963).

[66] Section 60(a); 52 Stat. 869 (1938), 11 U.S.C. § 96 (1958).

[67] Section 9-204(2)(b).

shall be *deemed to be taken for new value and not as security for an antecedent debt.*" (Emphasis added.) There can be no mistake that the Code draftsmen clearly intended to eliminate the voidable preference threat to after-acquired property by virtue of Section 9-108.[68] However, a serious question is presented whether such a provision of state law could subordinate federal bankruptcy law.[69]

An answer to the lender's security needs in this context must be sought not in the ritualistic language of Section 9-108, but rather from a careful analysis of the nature of a security interest in hydrocarbons prior to, as well as after, extraction. If an interest in oil and gas in place is an interest in real estate subject to the real estate recording laws, it follows that proper recording of the mortgage in the real estate records would perfect the lender's lien as to oil and gas in place. If the lender concurrently filed a financing statement under the Code as to extracted hydrocarbons, contract rights, accounts and proceeds, and such recording and filing was completed over four months prior to the filing of the petition in bankruptcy, Section 60(a) of the Bankruptcy Act should offer no obstacle to the lender. Section 60(a)(2) provides the following test as to when a "transfer" of property of the bankrupt occurs:

> [A] transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so for perfected that no subsequent bona fide purchaser from the debtor could create rights in such property superior to the rights of the transferee.

If real estate recording and Code filing were accomplished over four months prior to the filing of the petition in bankruptcy, the lender's interest in the oil and gas in place is invulnerable to attack by a subsequent bona fide purchaser. Moreover, the lender's security interest in extracted hydrocarbons and proceeds is also invulnerable to attack by a lien creditor at any time subsequent to the moment of extraction of the hydrocarbons. Thus, the lender could assert that his security interest was continuously perfected from the moment of recordation of the real estate mortgage, nothwithstanding the metamorphosis which the collateral underwent upon extraction

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[68] See Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses under the Code,* 108 U. PA. L. REV. 194 (1959).

[69] The supremacy clause of the United States Constitution poses a formidable obstacle to the realization of the objectives of § 9-108, which may conflict with § 60(a) of the Bankruptcy Act. See 3 COLLIER, BANKRUPTCY, § 60.51 A (7.2) (1964). See *In re* Portland Newspaper Publishing Co., 4 C.C.H. INSTAL. CREDIT GUIDE ¶ 98483 (Ore. 1966) (discussed in Editor's Note; *supra*).

according to the traditional law of realty and personalty. A forceful analogy can be drawn from the cases which hold that substitution of new security for old security does not ordinarily create a preference because *there is no resultant diminution of the debtor's estate to the injury of other creditors.*[70]

The difficulty with this analysis is that, although an interest in unextracted hydrocarbons may be an interest in real estate for recording purposes, the debtor does not acquire rights in oil and gas, as *personalty,* until extraction. Conceptually, at the moment of extraction there is an instantaneous change in the nature of the collateral from realty to personalty and a correlative "transfer" to the creditor. As a practical matter, the oil extracted is much more valuable than the oil in place. Because a time-gap is created between the loan and the "transfer," the danger of a voidable preference is substantial. Moreover, if the lender takes only a naked assignment of proceeds of production without an accompanying real estate mortgage on the leasehold itself, the danger of a voidable preference is greatly increased. In such case the lender cannot refer to an earlier recording date for purposes of establishing a continuous perfection which antedates the four month preference period.

The oil and gas lender should also be wary of another pitfall pertaining to bankruptcy proceedings. If the lender records the mortgage in the real property records and files a Code financing statement which merely covers *proceeds* of production rather than *extracted hydrocarbons and proceeds,* the trustee in bankruptcy may argue that a gap in perfection of the security interest exists between the moment of extraction and the birth of proceeds upon sale of the hydrocarbons. This argument would be particularly persuasive with respect to oil held in storage tanks on the leasehold before delivery to the purchaser. The existence of the "gap" period would fortify the trustee's argument that the "transfer" contemplated by Section 60(a)(2) occurred at the time when the proceeds came into existence, and that a lien creditor levying during the "gap" period (which was only *scintilla juris*) could have obtained priority over the bank. To avoid this trap, the lender should always file a financing statement which covers extracted hydrocarbons, contract rights, accounts and proceeds.

The danger of voidable preference is also increased if the lender

[70] Stewart v. Platt, 101 U.S. 731 (1879); Cook v. Tullis, 85 U.S. (18 Wall) 332 (1874); Manchester Nat'l Bank v. Roach, 186 F.2d 827, 831 (1st Cir. 1951) (dictum); 3 COLLIER, *id.*, § 60.20.

waits to file a Code financing statement covering extracted hydrocarbons and proceeds until some time after recording the real estate mortgage but before production is actually obtained.[71] This would allow the trustee to argue that the lender had not done everything possible to obtain immediate and continuous perfection and that such tardiness should make the court favor more the formalistic preference argument set forth above. With this possibility in mind, the lender would be well advised to record immediately as to realty and to file immediately under the Code as to extracted hydrocarbons and proceeds.

Even if the above-described pitfalls are avoided, until the preference problem is resolved by decisional law the lender must face the possibility that four months of production attributable to the interest of the debtor may be lost to the trustee in bankruptcy despite the lender's full compliance with all applicable recording and filing provisions. The lender may take some small consolation in the fact that oil and gas in place at the time of filing of the petition in bankruptcy will be covered by the perfected lien of the real estate mortgage, and thus, proceeds of production accruing after the filing of the petition in bankruptcy will not be subject to the grasp of the trustee under the preference provision.[72]

VII. THE STATUTORY LIEN

The relationship between statutory liens and Article 9 will also be of concern to Code lenders dealing with oil and gas. A statutory lien upon oil and gas in place or fixtures will be governed by the rules applicable to real estate transactions, but the Code will come into play when extracted hydrocarbons or other types of personalty are covered by a statutory lien.

The Colorado statute which grants a lien against oil and gas properties for labor or materials supplied in the development and operation of the leasehold[73] creates a number of problems if such lien is sought to be applied to personalty situated on the leasehold or to extracted hydrocarbons and proceeds. If the statutory lien claim-

[71] This situation may arise where a loan is made to finance the development of an unproven leasehold. National banking associations, however, are not ordinarily authorized to take the unproven leasehold as collateral for such a loan. 55 Stat. 62 (1941), 12 U.S.C. § 371 (1958).

[72] 3 COLLIER, *op. cit. supra* note 69, § 60.32.

[73] COLO. REV. STAT. § 86-5-1 (1963) provides:

> Every person, firm or corporation, whether as contractor, subcontractor, materialman, or laborer, who performs labor upon or furnishes machinery, material, fuel, explosives, power or supplies for sinking, repairing, altering or operating any gas well, oil well or other well, or for constructing, repairing or operating any oil derrick, oil tank, oil pipeline or water pipeline, pump

ant files a lien statement within the six month filing period[74] and commences a suit to foreclose the lien within six months after the date of filing the statement,[75] the priority of the statutory lien is regulated by Section 86-5-3 of the 1963 Colorado Revised Statutes, which provides:

> No chattel mortgage shall be valid as against any person, firm or corporation entitled to a lien under the provisions of this article; provided, that no *mortgage, lien or other incumbrance existing and recorded as provided by law at the time of the inception of the lien* herein provided for shall be affected thereby. (Emphasis added.)

Because the statutory lien may relate back to the first item of material furnished or labor performed, or the commencement of work, and because the six month filing period runs from the date of the last item, it is possible that a lien statement may be filed well over six months after the inception of the statutory lien. During the interval period, security interests in the same collateral may be perfected under the Code, thereby creating a question as to the priority to be accorded the conflicting security interests. At first impression, Section 9-310 appears to resolve the conflict in favor of the lien claimant. As adopted in a modified form in Colorado, that section states:

> When a person in the ordinary course of business furnishes services or materials with respect to goods subject to a security interest, *a lien upon goods in the possession of such person given by statute* or rule of law for such materials or services *does not take priority over a perfected security interest unless a statute expressly provides otherwise.* (Emphasis added.)[76]

> or pumping station, transportation or communication line, gasoline plant or refinery, by virtue of a contract express or implied, with the owner or lessee of any interest in real estate, or with the trustee, agent or receiver of any such owner, part owner or lessee, shall have a lien to secure the payment thereof upon the properties mentioned, belonging to the party or parties contracting with the lien claimants, and upon the machinery, materials and supplies so furnished, and upon any well upon and in which such machinery, materials and supplies shall have been placed and used, and upon all other wells, buildings and appurtenances, *and the interest, leasehold or otherwise, of such owner, part owner or lessee* in the lot or land upon which said improvements are located, or to which they may be removed, to the extent of the right, title and interest of the owner, part owner or lessee, *at the time the work was commenced or machinery, materials and supplies were begun to be furnished by the lien claimant* or by the contractor under the original contract; *and such lien shall extend to any subsequently acquired interest* of any such owner, part owner or lessee. (Emphasis added.)

It is also possible for the lien claimant to proceed under the provisions of the General Mechanics' Lien Law, COLO. REV. STAT. §§ 86-3-1 to -24 (1963). However, the provisions pertaining to the specific statutory lien on wells and equipment allow for a lengthier filing period (six months) than the provisions of the General Mechanics' Lien Law (three months). In either case, it is assumed for purposes of the discussion to follow that the statutory lien claimant has elected to proceed under COLO. REV. STAT. §§ 86-5-1 to -11 (1963).

[74] COLO. REV. STAT. § 86-5-4 (1963).

[75] COLO. REV. STAT. § 86-5-5 (1963).

[76] COLO. REV. STAT. § 155-9-310 (1963).

It should be noted that the Colorado version of Section 9-310 differs from the Official Text version, which grants priority to the statutory lien unless the statute expressly provides otherwise. Although the presumption of priority has been reversed in the Colorado version, the lien claimant may argue that section 86-5-3 of the 1963 Colorado Revised Statutes does "expressly provide otherwise" by subordinating "chattel mortgages" perfected after inception of the statutory lien.[77]

One of the requirements of Section 9-310 is that the lien claimant have the goods in his possession. This requirement severely limits the applicability of Section 9-310 to the statutory lien on oil and gas properties, as most claimants of this type of lien would not ordinarily meet the possessory requirement.[78]

On the other hand, the *operator* of the leasehold probably is in possession within the meaning of Section 9-310 as to the personalty located on the leasehold and the oil in the tanks.[79]. Because this pro-

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[77] For an interpretation that a lien statute referring to the priority of a "mortgage" is inapplicable to the priority of a Code "security interest" within the meaning of § 9-310, see Corbin Deposit Bank v. King, 384 S.W.2d 302 (Ky. 1964). Such a formalistic view, if adopted in Colorado, would emasculate COLO. REV. STAT. § 86-5-3 (1963), which expressly subordinates a "chattel mortgage" but not a "security interest."

[78] Assertion of a non-possessory statutory lien in bankruptcy proceedings against the debtor may raise a problem which is commonly referred to as the doctrine of "circularity." Section 67(c) of the Bankruptcy Act provides that "statutory liens on personal property not accompanied by possession of such property . . . shall be postponed in payment" to expenses of administration and wage claims. 66 Stat. 427 (1952), 11 U.S.C. § 107(c) (1966). Although the operator of oil and gas properties may be in possession within the meaning of § 67(c), laborers or materialmen would not be. Thus, assertion of a laborer's or materialman's statutory lien in bankruptcy proceedings against the debtor would bring § 67(c) into play. Because proceeds would not ordinarily be in the possession of the operator, laborer or materialman, assertion of a statutory lien as to proceeds [if allowed by COLO. REV. STAT. § 86-5-1 (1963)] would also invoke § 67(c). The following circularity problem might then ensue:

1) The statutory lien would be superior to the mortgage under Colorado law. COLO. REV. STAT. § 86-5-3 (1963).

2) Administrative expenses and wage claims would be superior to the statutory lien under bankruptcy law. 66 Stat. 427 (1952), 11 U.S.C. § 107(c) (1966).

3) The mortgage would be superior to administrative expenses and wage claims under bankruptcy law. 3 COLLIER, *op. cit. supra* note 69, § 57.07.

Where the statutory lien is superior to the mortgage but inferior to the priority claims, the courts have resolved the circularity by also subordinating the mortgage to the priority claims. *In re* Quaker City Uniform Co., 238 F.2d 155 (3d Cir.), *cert. denied*, 352 U.S. 1030 (1956); *In re* Einhorn Bros., Inc., 272 F.2d 434 (3d Cir. 1959). Under this hierarchy, the order of payment out of the bankrupt debtor's estate becomes:

1) Administrative expenses and wage claims.

2) Statutory lien.

3) Mortgage.

If the priority claims are substantial, the mortgagee's security interest may be seriously affected by the circularity which will ensue where a relatively small lien claim is asserted in a bankruptcy proceeding. For a view that § 67(c) is inapplicable to the priority of *secured claims* in bankruptcy see California State Dept. of Employment v. United States, 210 F.2d 242 (9th Cir. 1954); New Orleans v. Harrell, 134 F.2d 399 (5th Cir. 1943); *In re* American Zyloptic Co., Inc., 181 F. Supp. 77 (E.D.N.Y. 1960).

[79] Furthermore, the operator would appear to be performing "services" in the ordinary course of his business. See the Comment to § 9-310.

vision of the Code respects priority expressly accorded by the statute creating the lien, the operator may claim a statutory lien (independent of any contractual operator's lien)[80] perfected as of the date of commencement of operations on the leasehold.[81] Therefore, as against a Code security interest perfected after the commencement of work, the operator may claim statutory lien priority under section 86-5-3.

Even if the lender perfects a security interest *prior* to commencement of operations, a possibility exists that the security interest may be subordinated to the statutory lien if the statutory lien extends to severed hydrocarbons and proceeds. Because the statutory lien contains a provision regulating its priority as against a *chattel* mortgage, extracted hydrocarbons, as chattels, and the proceeds thereof arguably are subject to the statutory lien. Although the statute does not expressly state that extracted hydrocarbons and proceeds are subject to the lien granted, the statute does mention "the interest, leasehold or otherwise, of such owner, part owner or lessee" and further provides that the lien granted "shall extend to *any subsequently* acquired interest of any such owner, part owner or lessee."[82] In other states, similar statutory liens upon oil and gas properties have been held not to attach to extracted hydrocarbons or proceeds where the statutes involved did not expressly so provide.[83] Although such statutes referred to the leasehold interest, they did not contain a reference to "any subsequently acquired interest."[84] Whether, under the Colorado statute, the concept of "subsequently acquired interest" includes extracted hydrocarbons and proceeds will remain the subject of speculation until the point is litigated or otherwise resolved by legislative amendment.[85]

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[80] The operator will receive the greatest protection, not by relying on his statutory lien, but by including a lien provision in the operating agreement. Because the contractual lien covers extracted hydrocarbons and proceeds, the operating agreement is subject to the filing requirements of Article 9. See § 9-102(1)(a). The operating agreement, therefore, should conform to the requirements of a Code security agreement and be filed in the Secretary of State's office as well as in the real property records. In the alternative, the operator may file a financing statement. If such filing is delayed or omitted, the operator could presumably still rely on the statutory lien, subject to the assumption that such lien extends to extracted hydrocarbons and proceeds.

[81] In Colorado, there is strong authority for relation back to the date of initial leasehold operations. See Park Lane Properties, Inc. v. Fisher, 89 Colo. 591, 5 P.2d 577 (1939), where, under the general mechanics' lien statute, commencement of work was deemed to relate back to the planning stage prior to initial construction of the building.

[82] COLO. REV. STAT. § 86-5-1 (1963) (Emphasis added.).

[83] Tarheel Drilling & Equip. Co. v. Valley Steel Prods. Co., 231 Ark. 510, 330 S.W.2d 717 (1960); Stanolind Crude Oil Purchasing Co. v. Busey, 185 Okla. 200, 9 P.2d 876 (1939); Gary v. Rufus Lillard Co., 196 Okla. 421, 165 P.2d 344 (1946).

[84] The Nebraska statute expressly extends the lien to oil and gas produced from the lease, and the proceeds thereof. NEB. REV. STAT. § 57-803 (3) (Reissue 1960).

[85] See generally, Rodden, *The Bankruptcy Act and the Independent Producer*, 9 ROCKY MOUNTAIN MINERAL LAW INSTITUTE 337 (1964).

Assuming, however, that the statutory lien does apply to extracted hydrocarbons and proceeds, a troublesome question of priority is presented. The lender who has properly perfected his security interest in extracted hydrocarbons and proceeds under Section 9-306 may find the collateral pumped out from under his mortgage and into the hands of the statutory lien claimant. This is because the lender's security interest *in extracted hydrocarbons* cannot attach until the moment of extraction,[86] while the statutory lien can relate back to a point in time prior to extraction. In other words, Section 9-204(2)(b) makes it impossible for any "mortgage, lien or other encumbrance" on the extracted hydrocarbons and proceeds to "exist" before "the inception" of the statutory lien, within the meaning of section 86-5-3. Therefore, if the leasehold operator has possession of extracted hydrocarbons and proceeds, he may claim a statutory lien with priority over a previously perfected Code security interest.[87].

A counter-argument, similar to that raised in the voidable preference context, is applicable where a real estate mortgage encumbers the leasehold prior to commencement of operations. The argument is that the lender's interest in extracted hydrocarbons relates back to the recording of the real estate mortgage and establishes a continuous perfection. Moreover, the lender, by recording and Code filing has utilized all available means of perfection. Such diligence is all that section 86-5-3 asks as a condition of priority. Therefore, the lender's security interest in extracted hydrocarbons and proceeds should not be treated as a "chattel mortgage" interest within the meaning of the statute, but rather as a real estate mortgage interest. Whether this argument will be accepted by the courts in light of Section 9-204(2)(b) can only be open to conjecture.[88]

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[86] Section 9-204(2)(b).

[87] If the operator does not have possession of the runs the same priority problem is presented. The only difference is that § 9-310 is not involved, and priority turns solely upon the construction of § 9-204(2)(b) in relation to COLO. REV. STAT. § 86-5-3 (1963).

[88] Extension of the statutory lien to extracted hydrocarbons and proceeds presents a serious problem for the production purchaser in Colorado. COLO. REV. STAT. § 86-5-7 (1963) provides that the transferee of property subject to the statutory lien takes subject to the lienor's rights, regardless of lack of notice. This result is in direct opposition to § 9-307 of the Code, which allows production purchasers in the ordinary course to take free of any "security interest" in the oil and gas. However, § 9-102(2) provides that Article 9 does not apply to statutory liens except as provided in § 9-310. Therefore § 9-307 is of no avail to the production purchaser if a non-possessory statutory lien is involved. But if the operator asserts a contractual lien, it is arguable that the Code comes back into play to preempt COLO. REV. STAT. § 86-5-7 (1963) as "inconsistent." See §§ 9-102(1)(a) and 10-103.

In contrast, the Nebraska operator's lien statute contains a provision similar to § 9-307 of the Code, which protects buyers in ordinary course from the operator's lien. NEB. REV. STAT. § 57-806 (1960); *Young, The Nebraska Oil and Gas Lien*, 41 NEB. L. REV. 572, 579 (1962).

VIII. Federal Tax Liens

The after-acquired nature of extracted hydrocarbons and proceeds may create problems concerning priority of federal tax liens. To be considered "choate" as against a federal tax lien, a security interest must be specific and definite in the following respects: (1) identity of the lienholder, (2) amount of the lien, and (3) property subject to the lien.[89]

If a lender files a financing statement which covers extracted hydrocarbons, accounts and proceeds and a federal tax lien is subsequently filed against the debtor, does the lender have a "choate" lien upon production which accrues after the filing of the tax lien? A recent bankruptcy case[90] suggests that a perfected Code security interest in unaccrued accounts is inchoate. In that case, accounts representing the proceeds of contracts not in existence at the time of filing of the tax lien were held to be indefinite and the assignment of accounts was therefore subordinated to the tax lien.

However, the bankruptcy case involved accounts arising under contracts for ship repair services rendered by the debtor. An important distinction as to the nature of the accounts can be made with respect to a security interest in extracted hydrocarbons and proceeds. As to oil and gas in place, a properly recorded mortgage is choate vis-a-vis a subsequently filed federal tax lien. Where the lender both records his mortgage as a real estate mortgage and files under the Code as to extracted hydrocarbons and proceeds, a forceful argument may be made that the lien, once choate, is not rendered inchoate by transformation of the collateral from realty to personalty upon extraction.

This argument is fortified by *Elliott v. Sioux Oil Co.*[91] The *Elliott* case involved an assignment of proceeds of oil and gas production. The assignment was recorded in the real estate records of the county prior to the filing of a tax lien against the assignor. It should be noted that the assignee did not take a formal mortgage of the leasehold estate. Nevertheless, the court reasoned that the assignment was executed as security for a debt and, thus, constituted a mortgage. Because the subject of the "mortgage" was minerals to be extracted, the court held that the assignment affected real estate and was subject to the rules of perfection of liens upon real estate. Prior recordation of the assignment in the real estate records per-

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[89] United States v. City of New Britain, 347 U.S. 81 (1954).

[90] *In re* Hudon & Son, Inc., 65-2 U.S. Tax Cas. ¶ 9517 (D. Mass. 1964).

[91] 191 F. Supp. 847 (D. Wyo. 1960).

fected the lien and eliminated any question as to specificity of proceeds which accrued after filing of the tax lien.

Although the *Elliott* case did not involve the Code, the reasoning of the court would appear to be equally applicable to Code security interests in extracted hydrocarbons and proceeds. However, due to the fugacious nature of hydrocarbons, the lender can never be certain that his collateral will be realized until the moment of extraction. This uncertainty, coupled with the Code rules for perfection as to extracted minerals, will continue to be a risk to the oil and gas lender with respect to competing federal tax liens.

IX. FIXTURES

In oil and gas financing security interests in fixtures are particularly important, because often much of the collateral involved is attached to the land in some way. Tanks, casing, pipelines, and residences for field personnel on the leasehold are among the most recurrent examples. Given this fact, the oil and gas financer, under the typical production or development loan, will be dealing constantly with Section 9-313 of the Code, which governs priorities among conflicting security interests in fixtures.

In the oil and gas context, the conflict will typically be between the bank generally financing development of the leasehold (Bank "D"), and the bank financing the purchase of equipment likely to become fixtures (Bank "P"). More specifically, the conflict will be between Bank D's mortgage on real estate and personalty, which mortgage contains an after-acquired property clause, and Bank P's purchase money security interest[92] in the equipment to be affixed to the leasehold. Bank P will seek to preserve its purchase money security interest in the equipment to avoid feeding the after-acquired property clause in Bank D's mortgage.[93]

Section 9-313(1) of the Code will probably not be relevant to ordinary oil and gas financing. That section provides:

> The rules of this section do not apply to goods incorporated into a structure in the manner of lumber, bricks, tile, cement, glass, metal work and the like and no security interest in them exists under this Article unless the structure remains personal property under applicable law.

Apparently, such incorporated materials become part of the

[92] Section 9-107 provides a definition of this term.

[93] For a discussion of this general situation, see Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333, 1388-1398 (1963). Two subsidiary points should be mentioned. First, if the debtor owns the equipment outright, there will be no conflict and Bank D's collateral will be increased by the amount of the value of the equipment, whether it is after-acquired or not. But if the debtor has merely leased the equipment, Bank D's security interest cannot rise above the debtor's interest as lessee.

realty subject to real estate recording laws. It is possible to conceive of items such as well casing in place and buried pipelines as "metal work . . . incorporated into a structure" in a manner similar to "lumber, bricks, tile," etc.[94] However, it is difficult to imagine a situation in which other types of equipment would be so incorporated into the leasehold. Equipment such as tanks, pumps, surface pipelines and related machinery used in oil and gas operations are only temporarily affixed to the land. Therefore, Section 9-313(1) appears to be inapplicable to such temporarily affixed equipment.

The other parts of Section 9-313 are, however, very relevant to oil and gas financing. The section provides a system of priorities among conflicting security interests in "fixtures," the definition of "fixtures" being left to state (Colorado) law. Section 9-313(1) also provides:

> This Act does not prevent creation of an encumbrance upon fixtures or real estate pursuant to the law applicable to real estate.

Probably the most important provisions are Section 9-313(2) and (4), which state in part:

> A security interest which attaches to goods before they become fixtures takes priority as to the goods over the claims of all persons who have an interest in the real estate except [subsequent transferees of any interest in the real estate, a creditor subsequently levying on the realty or a prior mortgage of the realty making subsequent advances, if the subsequent transfer, levy or advance is made without knowledge of the security interest and before it is perfected.]

Thus, if Bank P's purchase money security interest in the equipment "attaches" before the equipment is affixed to the leasehold, Bank P has priority to the equipment over Bank D, even if Bank P never files or records its interest in the chattel or realty records. This assumes, however, that Bank D executes its mortgage on the debtor's interest *before* the "attachment" of the purchase money security interest of Bank P, and that Bank D does not make "subsequent advances." If the purchase money interest predates the development loan, then Bank P is required under Section 9-313(4) to

[94] If well casing in place and buried pipelines are "structures" within the meaning of § 9-313 (1), the Code rules of priority will not apply unless such items remain "personal property" under Colorado law. This subsection emphasizes the manner of affixation of the completed structure as the sole criterion to determine whether the structure and all of its integral parts constitute realty or personalty. However, "the applicable law" of Colorado, as discussed in detail in the text immediately following, emphasizes other criteria to determine the same question.

One of the traditional tests by which to classify property as a fixture of personalty is whether the property may be removed "without material injury to the freehold." This concept is completely abandoned by the Code, which requires only that the secured party who removes the collateral from the real estate reimburse any encumbrancer or owner of the real estate (other than the debtor) for *any* physical injury caused by the removal. See § 9-313(5).

file in the county where the fixtures are located[95] with a description of the relevant land[96] in order to obtain priority over Bank D.

The difficulty with this analysis is that Section 9-313 only applies to "fixtures" as that term is defined by state law, and in Colorado there is a serious question (1) what a fixture is and (2) whether such a category — halfway between personalty and realty — exists at all as a separate category subject to priorities under the recording laws.

The general rule which appears to have emerged from the leading Colorado fixtures cases is that property must be either personalty or realty; although "fixtures" constitute a recognized category as a matter of *property* law, there is no intermediate category of "fixtures" insofar as *recording* priority is concerned. If a chattel mortgage is executed *before* physical annexation of the property, the property remains "personalty" free from any prior or subsequent real estate mortgage; if execution occurs *after* annexation, the chattel mortgage is subordinate to a prior real estate mortgage.[97]

Against this background of case law in Colorado it is possible that "fixtures," as an independent category of collateral under the recording laws, may not now exist. If Colorado eventually recognizes "fixtures," apart from realty or personalty, to accommodate state law to the structure of Section 9-313, then presumably the priorities of that section will govern conflicting security interests in items such as well casing, rigs, pipelines and the like. However, in the light of prior cases, it appears unlikely that the parties will create "fixtures" by so labeling such property in a security agreement. It is more likely under the Code, as adopted in Colorado, that oil and gas equipment will constitute either personalty or realty, depending solely upon whether the chattel security interest attached before or after affixation of the equipment to the leasehold.

This uncertainty could create a difficult filing problem for Bank P. If oil and gas equipment is financed by conditional sale before its affixation, a Colorado court might well term the equipment "personalty." As personalty, the equipment would no longer be within the scope of Section 9-313, which deals only with "fixtures." Rather, the filing rules applicable to "equipment" would apply,

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[95] Section 9-401(1)(b). Fixture filings must be cross-indexed from the local personalty records to the local realty records. Section 9-401(5).

[96] Section 9-402(1).

[97] See Beatrice Creamery Co. v. Sylvester, 65 Colo. 569, 179 Pac. 154 (1919); Razatos v. Daniels & Fisher Stores Co., 110 Colo. 105, 131 P.2d 417 (1942); Stapp v. Carb Ice Corp., 122 Colo. 526, 224 P.2d 935 (1950); STORKE & SEARS, COLORADO SECURITY LAW, § 24 (1955); Comment, *Colorado Fixtures Law*, 34 ROCKY MT. L. REV. 458 (1962); Coogan, *Security Interests In Fixtures under The Uniform Commercial Code*, 75 HARV. L. REV. 1319, 1343-1349 (1962). Clark, *supra* note 38 at 111-14.

namely, central filing.[98] If Bank P erroneously files as to "fixtures" in the county, when in fact the goods constitute "equipment," Bank D will prevail by virtue of its prior central filing (and the after-acquired property clause contained in Bank D's security agreement). The only safe course for the purchase money lender is dual filing, locally in the county where the property is first affixed, and centrally with the Secretary of State as to "equipment."[99] If the debtor uses property which will be moved from leasehold to leasehold, Bank P, to be protected as to "fixtures," need only file in the county where the property is *first* affixed.[100]

On the other hand, the collateral value of salvaged property is threatened by the local filing rules of the Code as to fixtures. If the property initially became a "fixture" prior to removal to another county and Bank P properly filed in the county where the property was first affixed, then neither Bank D nor any subsequent lender can safely assume that the salvaged property is unencumbered until the records of every Colorado county have been searched. To be safe, Bank P should have filed centrally as to "equipment," as well as locally as to "fixtures." Such central filing would have put Bank D and any subsequent chattel mortgagees on notice of the security interest without the inconvenience of local record searches. However, to the extent that Bank P was satisfied that it had a security interest in "fixtures" and chose to file only locally, Bank D and subsequent mortgagees are faced with a multi-county record search.

The uncertainty of the law concerning "fixtures" in Colorado dictates multiple Code filings by the conditional seller of oil and gas equipment and multiple searches by any subsequent lender interested in salvaged property as loan collateral. Until Section 9-313 is amended or Colorado law pertaining to "fixtures" is clarified, confusion is apt to reign in this area of oil and gas financing under the Code.

X. Transmitting Utility

Colorado has included a special provision in Article 9 applicable to pipeline companies as well as to other public utilities. The section will somewhat lessen the burden of financers of pipeline companies

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[98] Sections 9-312(4), 9-401. If P has a purchase money security interest within the meaning of § 9-107, then § 9-312(4) allows an extra ten days within which to file centrally as to "equipment." The ten day period runs from the date that the debtor receives possession of the collateral.

[99] Colorado has added § 9-401(5) to the Code. That section requires fixtures to be cross-indexed from the county personalty records to the county realty records. Such cross-indexing is inadequate, however, if *only personalty* is involved. In such case, only central filing with the Secretary of State is adequate.

[100] Section 9-401(3).

in Colorado.[101] This new section provides that a lender making loans to a "transmitting utility" on the security of pipelines and other equipment will be spared the necessity of filing financing statements in every county through which the pipelines extend — even if the collateral constitutes "fixtures."[102] Furthermore, no continuation statements will be necessary on a long-term loan and no description of the real estate is necessary as to "fixtures."

The definition of "transmitting utility" in Section 9-408 turns on whether the debtor conducts business "pursuant to the rights or franchises issued by a state or federal regulatory body." Certificates of public convenience and necessity are the most obvious examples of such "rights or franchises," but other types of governmental regulation may also bring the section into operation. If a carrier were exempted from state regulation as to isolated and private intrastate sales of gas, the section would presumably still apply if any other part of the company's activities were regulated by any other state or by the Federal Power Commission as to interstate activity.[103] In addition, any company which falls within the definition of "public utility" as defined by Colorado statute[104] would also appear to come within the scope of Section 9-408. Thus, pipeline companies making only selected sales to private consumers in Colorado may not be able to avail themselves of the benefits of Section 9-408. The same may also be true of pipeline companies making surplus sales to municipalities for resale to the general public.[105]

To be safe, the lender should first ascertain whether the debtor has obtained certificates of convenience and necessity from any state or the Federal Power Commission or whether proceedings exempting the debtor from regulation have taken place. If a certificate has

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101 Section 9-408 provides in part:

> Transmitting Utility . . . the proper place to file in order to perfect a security interest in goods of a transmitting utility shall be in the office of the secretary of state. When the financing statement covers goods of a transmitting utility which are or are to become fixtures, no description of the real estate concerned is required. The words 'transmitting utility' mean any corporation or other business entity primarily engaged, *pursuant to the rights or franchises issued by a state or federal regulatory body,* in the . . . transmission or distribution of oil, gas, or petroleum products . . . a security interest in goods of a transmitting utility perfected as provided above shall continue in effect in accordance with the terms of the security agreement without the necessity of filing continuation statements. . . . (Emphasis added.)

102 See §§ 9-401 and 9-402. However, it should be noted that no state adjoining Colorado has yet adopted a similar provision. Thus, financing an interstate pipeline may require multiple local filings in adjoining states, even though only one filing is necessary in Colorado.

103 142 Colo. 361, 351 P.2d 241 (1960). See Public Utls. Comm'n v. Colorado Interstate Gas Co., 142 Colo. 361, 351 P.2d 241 (1960).

104 COLO REV. STAT. 115-1-3 (1963).

105 See Public Utls. Comm'n v. Colorado Inter-state Gas Co., 142 Colo. 361, 351 P.2d 241 (1960).

issued, which will often be the case, then the lending institution may avail itself of the filing benefits of Section 9-408.

XI. Production Payment Financing

The code will play a vital part in the financing of production payments. So long as the leasehold remains undeveloped, the rules governing priority of security interests in real property are applicable. It is assumed that in Colorado an unaccrued production payment, like unaccrued royalty, is an interest in realty subject to the recording statutes.[106] However, the hydrocarbons when extracted become personalty subject to the requirements of Article 9. Therefore, along with the recording of the real estate mortgage, the lender should also centrally file a financing statement covering extracted hydrocarbons, accounts, contract rights and proceeds.[107]

Although proceeds of production accruing to the production payment will typically be paid directly to the lender and perfection may be accomplished by actual possession of proceeds,[108] perfection of *accounts* and *contract rights* may be achieved under the Code *only* by filing.[109] Before obtaining possession of the proceeds, the lender may be viewed as having a security interest only in such accounts and contract rights. For this reason, filing as to accounts and contract rights, in addition to extracted hydrocarbons and proceeds, is advisable. Such filing will allow the lien to cover the collateral through all its transmutations with no intervening gaps. As discussed previously, duplicate filings may be necessary if the debtor's record keeping office is located in another state.[110]

The usual pattern in production payment financing is for the bank to take an assignment of proceeds of production and to execute transfer and division orders providing for payment of the specified cash proceeds directly to the bank until the indebtedness is satisfied.[111] While there are business reasons for such payment directly to the bank (such as prepayment of the note and protection in case of default), the bank's security interest in the proceeds would not be

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[106] See the textual discussion *supra* pp. 4-7.

[107] The real estate mortgage can double as a Code security agreement and, if all the formal requirements are met, be filed in lieu of a financing statement. See § 9-402(1).

[108] Section 9-305.

[109] Section 9-302. Although it is common practice to include a receivership provision in the production payment mortgage, such provision may not afford protection against the claims of intervening creditors as to accounts or contract rights unless a filing is made as to accounts, contract rights and proceeds.

[110] Section 9-103(1).

[111] See Johnson, *Legal Aspects of Oil and Gas Financing*, Ninth Annual Institute on Oil and Gas Law and Taxation, p. 158 (1958).

endangered by allowing the debtor to have dominion over them. Section 9-205 of the Code specifically rejects and repeals the doctrine of *Benedict v. Ratner*[112] which endangers such a security interest under pre-Code law.

Payment of proceeds directly to the lender gives the lender an important added protection under the Code. Sections 9-306(4)(b) and (c) provide:

> In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest . . . in indentifiable cash proceeds in the form of money [or checks] which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings . . . .

If the lender allows the debtor to take possession of production payment proceeds or places such proceeds in the debtor's account and the proceeds become "commingled," the Code will limit the lender to recovery of an amount not greater than the amount of proceeds received by the debtor within ten days prior to institution of insolvency proceedings against the debtor.[113] On the other hand, it is common practice in production payment financing to provide for assignment of the proceeds to the lender to amortize the indebtedness. Thus, the possibility of commingling is eliminated and the proceeds are indentifiable at all times. To protect its security interest in proceeds, the lender should keep each production payment loan account separate from any other accounts arising out of other loan transactions involving the same debtor.

CONCLUSION

Adoption of the Uniform Commercial Code in Colorado will present a number of filing and priority problems for the oil and gas financer. Problems of transition to Code law will soon face lenders involved in long-term oil and gas financing transactions entered into under pre-Code law; Code filing, in addition to Land Office filing, will be required where personal property security interests in federal oil and gas leases are involved; the handy "mixed mortgage" recording provision presently applicable to mortgages by corporate debtors will be repealed, and both recording and Code filing will be required; Code filing will be necessary as to security interests in motorized equipment not covered by the Colorado Certificate of Title Act; filings may have to be made in other states as to accounts and contract rights if such constitute independent collateral, rather

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[112] 268 U.S. 353 (1925).

[113] Section 9-306(4)(d).

than mere "proceeds" of severed hydrocarbons; and proceeds of extracted hydrocarbons feeding a production payment or other mortgage may be claimed by the trustee in bankruptcy as a voidable preference. In addition, potential priority conflicts remain to be resolved between the statutory lien on oil and gas properties and Code security interests; a security interest in extracted hydrocarbons and proceeds may not be "choate" as against a federal tax lien, due to the after-acquired nature of such collateral; security interests in oil and gas equipment will be subject to the uncertainties of Colorado decisional law as to fixtures; questions will arise whether or not certain debtors are "transmitting utilities" subject to the liberal filing provisions of Section 9-408; and multi-state filings may be necessary in production payment financing transactions.

Nevertheless, the adoption of the Code will promote uniformity concerning the rules for perfection of consensual security interests in personalty. Although the Code was not drafted with oil and gas financing foremost in mind, the oil and gas lender may reap the security benefits intended. A measure of caution, often involving multiple filings, will reduce risks to a minimum.