

Client Alert

Finance & Restructuring Practice Group

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Third Circuit Rejects Unsecured Oil Producers' Claims of Automatic Perfection

On July 19, 2017, the U.S. Court of Appeals for the Third Circuit (the "Court") issued an opinion, upholding a district court's ruling that downstream purchasers took oil purchased from a bankrupt intermediary, SemGroup L.P. (collectively with its affiliates including SemCrude L.P.), free and clear of the oil producers' purported liens.¹

Background and the Bankruptcy Court Decision

In a fact setting that is typical for an interstate transaction: oil was produced by a collection of producers and then purchased by a midstream company, SemGroup. Thereafter, SemGroup transported and/or stored the oil and, at the same time, commingled the producers' oil with oil purchased from a multitude of other producers. SemGroup then sold the oil to a downstream buyer. The downstream buyer would buy for value, in the ordinary course, and without information regarding the source of the underlying production and without communicating with the producers.

The Appellants, the oil producers, sold their product to SemGroup. SemGroup then sold oil to and traded oil futures with the Appellees—the downstream oil purchasers (J. Aron & Company and BP Oil Supply Co.).

Unlike the downstream purchasers, the producers failed to protect themselves in case of SemGroup's insolvency. In the case of default, the downstream purchasers could set off the amount that they owed SemGroup for oil with the amount that SemGroup owed them for the value of outstanding future trades. When SemGroup filed for bankruptcy in 2008, the downstream purchasers were paid in full while the oil producers were only paid in part.

Displeased with only a partial recovery, the producers brought claims against the downstream purchasers under theories of fraud, priority security interests under Texas and Kansas laws, and an implied trust theory under the Oklahoma Production Revenue Standards Act ("PRSA"). Essentially, the producers contended that a lien or trust followed the oil from their wells to the eventual hands of downstream buyers. To support this contention, the producers argued that non-uniform provisions of the Texas and Kansas Uniform Commercial Code ("U.C.C.") automatically granted a perfected security interest in the oil sold to SemGroup—even after it was sold to third

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parties. The bankruptcy court rejected these theories. Like other commingled goods, the producers' could not trace their oil. Furthermore, the downstream purchasers took oil purchased from SemGroup free and clear of the oil producers' liens because the purchasers were "buyers for value" and "buyers in the ordinary course." The district court affirmed.

Decision on Appeal

The Court considered several appeals arising from the Chapter 11 bankruptcy case of SemGroup, SemCrude, and their affiliates. Detailing the collapse of SemGroup, the Court noted that options deals, based on oil market price speculation, led to the company's eventual bankruptcy.

Calling the bankruptcy and district court opinions "superbly reasoned," the Third Circuit panel affirmed. The Court held that the oil producers failed to perfect security interests in accordance with the local laws of Delaware and Oklahoma—the "home" states of SemGroup—which both required the filing of U.C.C.-1 financing statements. Further, the Court noted that the downstream purchasers acquired the oil without any actual knowledge of the producers' interests and in express reliance on "the industry standard Conoco General Provisions, which expressly disclaim the existence of any continuing security interest" While the Court noted that the producers theoretically could have perfected their security interests, it noted that such precautions would be impracticable, as midstream and downstream oil producers would be unlikely to buy encumbered oil as it changed hands and flowed through interstate commerce.

The Court also rejected the Oklahoma producers' arguments that the PRSA provided for an "implied trust." Not only did the PRSA not include "provisions relating to downstream purchasers," but the Court also concluded that the 2010 Oklahoma Lien Act merely crystalized the fact "that downstream purchasers could avail themselves of buyer defenses." Thus, the Court held that "the PRSA did not create an implied trust."

Conclusion and Lessons Learned

The decision provides a cautionary tale for oil producers who believe that they have security interests in oil sold to midstream companies. Specifically, producers should be aware that courts will look to the state lien laws and U.C.C. of a midstream company's "home state(s)" to determine whether the producers are, in fact, secured. While Texas, Oklahoma and Kansas state laws each provide limited protections for producers, those protections will unlikely reach downstream parties in the event of a midstream company's bankruptcy. Thus, producers would be wise to not rely on an individual state's automatic perfection laws to protect them in the event of a midstream company's insolvency and seek other protections to guard against such situations.

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¹ *In re SemCrude L.P.*, --- F.3d ---, 2017 WL 3045889 (3d Cir. July 19, 2017).