

Fifth Circuit Affirms Bank's Perfected Delaware UCC Lien Has Priority Over Texas Oil Producers' Statutory Lien on Proceeds

WRITTEN BY

Deborah J. Enea | Alexandria R. Taylor

The Uniform Commercial Code was established to provide predictability and conformity in commercial transactions. Certain states have adopted nonstandard UCC provisions, which create an unreliable and unpredictable market for secured creditors. In addition, statutory liens, which are liens arising under federal and state statute, may disrupt the priority of secured creditors' interest in a debtor's assets. *In re First River Energy, L.L.C.* (986 F.3d 914, 917 (5th Cir. 2021)) illustrates the issues arising from the competing interests of secured creditors under the laws of different states.

In this case, the Fifth Circuit upheld a decision by the U.S. Bankruptcy Court for the Western District of Texas, which found that in the bankruptcy of a debtor incorporated in Delaware, Delaware law governed the competing interests between Texas oil and gas producers and bank lenders in the debtor's assets. As a result, the Texas producers' statutory lien was subordinate to the lender's perfected lien under the Delaware UCC. In contrast, the Oklahoma Lien Act protected Oklahoma oil producers by giving them a statutory lien based in real property law, which is not pre-empted by the Delaware UCC.

Secured lenders should be aware of statutory liens that may take priority over the lenders' liens in a debtor's bankruptcy. Lenders should modify their diligence and run additional searches to mitigate risk.

Statutory and Other Hidden Liens

Bankruptcy cases frequently involve challenges concerning the validity, extent, and priority of secured creditors' security interests. Some liens may not be disclosed in standard tax, lien, and judgment searches that may affect the priority of lenders' security interests. These "hidden" liens, including statutory liens, may prime the creditor's liens in bankruptcy.

Statutory liens do not require the consent of, or a security agreement with, the debtor. The creditor has the right to impose a statutory lien on the property of the debtor because of the relationship between the creditor and the debtor. For example, landlords have rights to impose landlord liens on tenants' personal property as security for lease payments. Other statutory liens include bailee (or warehouseman's) liens and unemployment compensation and workers' compensation liens.

The Case

Debtor First River Energy LLC is a midstream service provider in the oil and gas industry, headquartered in Texas and organized in Delaware. Midstream providers, also known as first purchasers, typically purchase oil and gas from upstream producers that extract hydrocarbons, then market to downstream purchasers, such as refineries, retailers, marketers, or commodities traders. First River purchased crude oil and condensate from Texas and Oklahoma upstream producers, which it then sold to downstream purchasers. First River filed for Chapter 11 bankruptcy in January 2018, without having paid the Texas and Oklahoma upstream producers for the oil it purchased.

To mitigate the risk that midstream providers may not pay upstream producers, some states, such as Texas and Oklahoma, have enacted statutes (Texas UCC § 9.343 and the Oklahoma Oil and Gas Owners' Lien Act of 2010), providing upstream producers with an automatically perfected security interest in the oil and gas conveyed to first purchasers until the upstream producer is paid in full. Both the Oklahoma producers and the Texas producers in the First River case asserted statutory liens in Oklahoma and Texas, respectively, on the production and the proceeds of the sales to First River.

Deutsche Bank Trust Company Americas, along with other banks and financial institutions, made a loan to First River before it filed for bankruptcy. Deutsche Bank perfected its security interest in the proceeds of the sale by filing UCC-1 financing statements in Delaware. First River defaulted under the loan. Deutsche Bank filed an adversary proceeding as a secured creditor in the bankruptcy, seeking a determination that it had priority in the proceeds of the sale.

Discrepancies Between the Texas and Oklahoma Statutes

The court determined that Delaware law applied to the Texas producers. The Delaware UCC does not include the nonuniform Texas first-purchaser provisions from Texas UCC § 9.343, so the court disregarded the protective Texas statute. Applying Delaware law, the Fifth Circuit affirmed that Deutsche Bank had a perfected, first priority security interest over the Texas producers through its filed Delaware UCC-1 financing statement.

In contrast, the Fifth Circuit found that the Oklahoma producers' lien had priority over that of Deutsche Bank. The Oklahoma Lien Act differs from the Texas UCC statute in that the liens arise in connection with the materials on the related real property interest as opposed to security interests arising on personal property under the Oklahoma UCC. The Delaware UCC does not preempt other states' non-UCC statutory liens based in real property law, so Deutsche Bank's security interest was subordinate to the Oklahoma producers' statutory lien.

While both the Texas UCC statute and the Oklahoma Lien Act were designed to protect their respective states' oil and gas producers, the Oklahoma Lien Act avoids the weakness of the Texas UCC statute by grounding the statutory right in property law so that its purpose is carried out.

Takeaways

Although the Texas government is contemplating legislation to fix the shortcomings of the Texas statute through House Bill No. 3794, the law remains unchanged. Texas oil and gas producers should ensure that their security interests have priority by filing UCC financing statements in lieu of relying on Texas's shaky statutory scheme.

More broadly, although this case played out in favor of the secured creditor in Texas, results may differ elsewhere. Secured creditors should be aware that certain aspects of transactions, such as the industry of the debtor, could give rise to hidden liens. Secured creditors should be mindful of statutory liens and conduct their diligence appropriately by:

- determining whether there are any statutory liens under state or local law where the debtor is located or particular to the industry or business of the debtor;
- conducting lien searches in counties where the debtor owns any real property; and
- asking the debtor to disclose any liens or security interests and any disputes, claims, or litigation that may give rise to liens.

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