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THE IMPACT OF THE UNIFORM COMMERCIAL CODE ON OIL AND GAS LEASES

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I. Introduction.

A. Scope of Outline.

The Uniform Commercial Code (the "U.C.C."**) consists of hundreds of statements of contract law rules and has been adopted in 49 of 50 states. In terms of America's common law, as inherited from England, the U.C.C. is a relative newcomer, first being endorsed by the American Bar Association in 1962, with major revisions in 1972. After its endorsement, states rapidly jumped on board to promote commercial uniformity throughout America. As a result of its newness, however, the U.C.C.'s impact on more traditional oil and gas law has been limited. But in the future this pattern may change as courts become more willing to impose the U.C.C. either directly or by analogy into areas traditionally governed by common law rules, a trend which has occurred in other areas. See e.g. Murray, "Under the Spreading Analogy of Article 2 of the Uniform Commercial Code", 39 Fordham L. Rev. 447 (1971). This trend is likely to continue, since the U.C.C. is generally considered the most comprehensive and complete legislative statement of modern contract rules and principles.

Of the 11 adopted and 2 proposed U.C.C. articles, Article 2, dealing with sale transactions, and Article 9, dealing with collateral assignments, are the most likely to affect oil and gas leases. Other articles, however, may peripherally relate to oil

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**Unless otherwise stated, the section citations throughout this outline are to the 1972 version of the Uniform Commercial Code as published in selected commercial statutes (West 1987). Arkansas, Oklahoma and Texas have adopted this version.
and gas transactions. For example, Article 3 (Commercial Paper) governs many aspects of mineral lease drafts. To narrow this outline's scope to manageable size, however, it generally is limited to the impact of Articles 2 and 9 on oil and gas leases, without considering the influence of other U.C.C. provisions. Because many readers are from or have dealings in Arkansas, Oklahoma and Texas, where possible this outline also concentrates on the law of those states.

B. General Scope of U.C.C. Articles 2 and 9 and Oil and Gas Transactions.

To understand the U.C.C.'s impact on oil and gas leases it is first necessary to review the scope of Articles 2 and 9 and how they may relate to oil and gas transactions. As a general rule Articles 2 and 9 only apply to agreements involving personal property. Thus, whether oil and gas interests are classified as real estate or personalty under state law is critical in determining the applicability of the U.C.C. As anyone familiar with oil and gas law knows, however, courts have classified oil and gas interests in many different ways. For example one commentator has listed the following classifications of oil and gas leasehold interests in different jurisdictions:

"a profit a pendre, a corporeal hereditament, an incorporeal hereditament, an estate in land, not an estate in land, an estate in oil and gas, not an estate in oil and gas, a servitude, a chattel real, real estate, interest in land, not an interest in land, personal property, a free hold, a tenancy at will, property interest and the relation of landlord and tenant." 1A Sommers, "Oil and Gas", §152 at 371.

Traditional common law distinctions between real and personal property have been of limited use in classifying oil and gas interests, except by analogy. Courts struggling with the unique nature of oil and gas interests have compared them to wild animals, timber and crops. Hemingway, "Oil and Gas Law", §1.3 (1971 Ed.). Yet, such distinction is vital to determining whether the U.C.C. applies to a particular transaction.
1. Article 2. §2-102 states that Article 2 "applies to transactions in goods." The term "transactions" is nowhere defined by the U.C.C. but is broader than just sale contracts. *Hertz Commercial Leasing Corp. v. Transportation Credit Clearing House*, 6 UCC Rep. 132, 136, 59 Misc. 2d 226, 298 N.Y.S.2d 392 (N.Y. Civ. Ct. 1969) ("clearly a 'transaction' encompasses a far wider area of activity than a 'sale', and it cannot be assumed that the word was carelessly chosen.") See also *Owens v. Patent Scaffolding Co.*, 77 Misc. 2d 992, 354 N.Y.S.2d 778 (1974); *Burton v. Arterey Co.*, 279 Md. 94, 367 A.2d 935 (1977); and *May Co. v. Trusnik*, 54 Ohio App.2d 71, 375 N.E.2d 72 (1977). Nor does Article 2 expressly limit this scope, except to state that Article 2 does not (a) apply to contracts which are intended to operate as security transactions [§9-102(1)] or (b) "impair or repeal any statute regulating sales to consumers, farmers or other specified classes of buyers." §2-102 and Comment. With such a broad mandate, it is not surprising that as they become familiar with the U.C.C., courts are prepared to apply Article 2 to many types of commercial problems, including those involving oil and gas interests. The question for Article 2 is under what circumstances can oil and gas interests be deemed to be "goods".

2. Article 9. Article 9 applies "To any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures . . ." Unlike Article 2, Article 9 deals with all types of personal property, not just goods, but limits the type of transactions covered to those involving security interests. However, Article 9 generally makes it clear that the law of real estate mortgages should govern interests in oil and gas prior to extraction. The original 1962 U.C.C. version expressly stated that an Article 9 security interest cannot attach "in oil, gas or minerals until they are extracted." §9-204(2) (1962 version). Under the 1972 version of the U.C.C. this language was deleted, but §9-105(1)(h) now states that Article 9's definition of "goods" does not include "minerals or the like (including oil and gas) before extraction."
reader should note that Article 2 and Article 9 define "goods" differently and the fact that unextracted oil and gas are not Article 9 goods does not mean they are not Article 9 personalty. However, in addition to §9-105(1)(h), §9-104(J) expressly excludes from Article 9's scope "the creation or transfer of an interest in or a lien on real estate, including a lease or rents thereunder." Presumably the term "lease" is broad enough to include oil and gas leases. This analysis suggests that Article 9 does not cover oil and gas until they are extracted. But as will be seen, such a conclusion may be an oversimplification which can mislead the unwary.

3. Article 2A Leases. Subject to editorial revision, the National Conference on Commissioners on Uniform State Laws and the American Law Institute have issued a proposed final draft of U.C.C. Article 2A which deals with leases. Article 2A provides numerous commercial rules for lease transactions which in many ways parallel Articles 2's rules for sales. The question of whether Article 2A covers oil and gas leases is expressly answered. If adopted Article 2A "applies to any transaction, regardless of form, that creates a lease." As noted in the Article 9 discussion, the term "lease" generally is broad enough to reach oil and gas leases. But Article 2A's definition is narrower defining "lease" to be "a transfer of the right to possession and use of goods. . . ." §2A-103(j). "Goods" means "all things that are moveable at the time of identification to the lease contract, or are fixtures..., but the term does not include. . . . minerals or the like, including oil and gas, before extraction. . . ." §2A-103(h) (emphasis added). Thus, Article 2A on leases, clearly does not cover oil and gas or oil and gas leases before extraction.

C. The Nature of Oil and Gas Ownership Before Extraction Under State Law.

Based on this brief review of Articles 2, 2A and 9, it is important in defining the relationship between the U.C.C. and oil
and gas interests to first determine whether applicable state law classifies oil and gas interests before extraction as personal or real property. As previously suggested, this is not a straightforward inquiry. Because of the special nature of oil and gas, it is difficult to describe the rights of an oil and gas owner in conventional property terms and special rules have arisen reflecting this uniqueness. Eugene Kuntz in his "Treatise on the Law of Oil and Gas" Vols. 1-7 (1987 ed.) (herein "Kuntz") observes however, that all of the various theories of oil and gas ownership fall into one of two categories: (1) "ownership-in-place" or (2) "exclusive-right-to-take." Kuntz §2.4. Under ownership-in-place a landowner owns all oil and gas underlying his property, only subject to the law of capture. Under exclusive-right-to-take, oil and gas is the object of absolute ownership only after it is captured. Before capture the landowner only has an exclusive right to capture the oil and gas by drilling operations on his land.

As Kuntz notes, these ownership classifications are generally "of questionable utility and opinions may reasonably differ. . . ." Kuntz §2.4. Yet, they have influenced decisions relating to partition, remedies available for protection of ownership, measures of damages, recording statutes, ad valorem taxes and numerous other issues. They may also provide guidance as to how courts will treat oil and gas transactions under the U.C.C. Before considering U.C.C. applicability further, following is a summary of the ownership theories adopted by Arkansas, Oklahoma and Texas and their affect on the classification of oil and gas leases as personal or real property.

and easement in the land itself. Ownership of the underlying oil and gas does not pass until capture. *Pasteur v. Niswanger*, 226 Ark. 486, 270 S.W.2d 852 (1956). Thus, it has been said that under Arkansas law an oil and gas lease creates an interest which "is more than a mere license but represents an easement in the land itself." *Kuntz* §23.5. Based on this theory the Arkansas Supreme Court has held for example that:

a. **Recording.** Oil and gas leases and assignments of oil and gas leases are subject to real property recording statutes. *Wasp Oil, Inc. v. Arkansas Oil & Gas, Inc.*, 658 S.W.2d 397 (Ark. 1983).


c. **M & M Liens.** Leases, royalties and leasehold interests are subject to materialmens' and mechanics' lien statutes. *Roberts v. Tice*, 198 Ark. 397, 129 S.W.2d 258 (1939).

2. **Oklahoma.** Notwithstanding inconsistent language in Oklahoma Supreme Court cases, it is generally agreed that Oklahoma has adopted an exclusive-right-to-take theory. *Kuntz*, §23.23; and *Rich v. Doneghey*, 71 Okla. 204, 172 P. 86 (1918) c.f. law review articles at 31 Calif. L. Rev. 357, 13 Miss. L.J. 353 13 Tex. L. Rev. 391 and Sullivan, "Handbook of Oil and Gas Law." Thus, a lessee cannot acquire an interest or estate in the subject land, but instead gets a chattel real, profit-a-pendre or an incorporeal hereditament. *Rich v. Doneghey*, supra and *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697 (Okla. 1979) *Casper v. Neubert*, 489 F.2d 543 (10th Cir. 1973); and *Continental Supply Co. v. Marshall*, 152 P.2d 300 (10th Cir. 1945). A lease gives the grantee an interest which is an estate in land, but is not "real estate" within the meaning of certain Oklahoma statutes. In *Cate v. Arclon Oil Company, Inc.*, 695 P.2d 1352 (Okla. 1985) the Oklahoma Supreme Court observed "that although an oil and gas lease creates an interest or estate in realty, the interest is
not per se real estate." In accord Shields v. Moffitt, 683 P.2d 530 (Okla. 1984); Hinds v. Phillips Petroleum Co., supra; and De Mik v. Cargill, 185 P.2d 229 (Okla. 1971). See also §9-104 (excluding interests or lien on "real estate"). This hybrid characterization sometimes makes Oklahoma's law on the question of whether or not an oil and gas lease is personal property very unclear to both novices and part-time oil and gas practitioners. But generally, an oil and gas lease in Oklahoma is treated as real property rather than personal property. For example the Oklahoma Supreme Court has held:

a. **Statute of Frauds.** Oil and gas leases and assignments must comply with Oklahoma's non-U.C.C. statute of frauds. Woodworth v. Franklin, 85 Okla. 27, 204 P. 452 (1921) (lease) and David v. Lewis, 187 Okla. 91, 100 P.2d 994 (1940) (assignment).


c. **Recording.** To be effective against third parties, a lease, assignment or mortgage of a lease must be properly acknowledged and recorded. Davis v. Lewis, 187 Okla. 91, 100 P.2d 994 (1940) (assignment); Continental Supp. Co. v. Marshall, 152 F.2d 300 (10th Cir. 1945) (mortgage); and Carroll v. Holliman, 336 F.2d 425 (10th Cir. 1964).

d. **Homestead.** An oil and gas lease of a homestead requires the joint consent of husband and wife. Carter Oil Co. v. Popp, 70 Okla. 232, 174 P. 747 (1918).

e. **Quiet Title.** An oil and gas lessee who is not in possession can maintain a quiet title action. Franklin v. Margay Oil Corp., 194 Okla. 519, 153 P.2d 486 (1944).


h. Partition. An oil and gas lease is not "real property" within the meaning of statutes governing partition. Clark v. Mercer Oil Co., 139 Okla. 48, 281 P. 283 (1929).

i. Venue. An oil and gas lease is not "real property" within the meaning of venue statute requiring foreclosure actions to be brought in the county where the property is located. Widick v. Phillips Pet. Co., 173 Okla. 325, 49 P.2d 132 (1935).


k. Mortgage Recording Tax. Oklahoma's real estate mortgage tax is not payable on a mortgage of (1) "oil, gas and other minerals." Okla. A. G. Op. 65-117, or (2) oil and gas lease. Okla. A. G. Op. dated 8/24/56; but it is payable in case a "hard" mineral is specified in the collateral description (e.g. a mortgage on oil, gas, coal, bauxite and other minerals). See Okla. A. G. Op. 65-117.

3. Texas. Texas has adopted the ownership-in-place theory. Eliff v. Texon Drilling Co., 146 Tex. 575, 210 S.W.2d 558 (1948). Thus, Texas courts generally have held that an oil and gas lease "constitutes a conveyance of a determinable fee in the minerals" and is generally considered as an interest in real estate. Kuntz §23.26; Will Cockson v. Colorado River Municipal Water Dist., 426 S.W.2d 203 (Tex. Civ. App. 1968); Cherokee Water Co. v. Forderhouse, 641 S.W.2d 522 (Tex. 1982); Bil Lake
Oil Co. v. Reagan County, 217 S.W.2d 171 (Tex. Civ. App. 1949); and Sheppard v. Stanolind Oil & Gas Co., 125 S.W.2d 643 (Tex. Civ. App. 1939). Thus, unlike Oklahoma, a lessee's interest in oil and gas is real property for all of the following purposes:


g. Ad Valorem Taxes. Carroll v. Holliman, 336 F.2d 425 (10th Cir. 1964) (This case provides a good comparison between the Oklahoma and Texas approaches to classification.)

D. Classification of Other Oil and Gas Interests.

Many other oil and gas interests flow from oil and gas leases. These include royalty interests, working interests, overriding royalty interests, production payments and net profits interests. Because oil and gas leases are generally treated as interests in real property (as in Arkansas, Oklahoma and Texas) most courts treat these derivative interests the same way. Smith v. Smith, 60 N.W.2d 276 (W.D. 1953) and Bolack v. Hedles, 240 P.2d 844 (N.M. 1952). For example, in Oklahoma unaccrued royalties under an oil and gas lease are real property for the purposes of a lessor's estate. McCully v. McCully, 86 P.2d 786 (Okla. 1939); and Cuff v. Koslosky, 25 P.2d 290 (Okla. 1933). Similarly, royalties are real property under an appraisement.
statute. Cuff v. Koslosky, supra. Overriding royalty interests in future production are also an interest in real property. Meeker v. Ambassador Oil Co., 308 F.2d 875 (10th Cir. 1962); and Danciger Oil and Refinery Co. v. Burroughs, 75 F.2d 855 (10th Cir.); cert. den. 195 M.S. 79 (1935). These decisions are a straightforward analysis based on the relationship of these derivative interests to oil and gas leases. However, two of these interests should be considered in greater detail because by their very nature they are more removed from oil and gas leases. As Kuntz recognizes, mineral estate owners may grant or reserve rights that "do not constitute estates or interests in land. . . ." Kuntz §15.2. For example he notes that the grant of a "privilege to drill an oil well" is not a transfer of an interest in real property. Id. See also Collier v. Caraway, 140 S.W. 2d 910 (Tex. Civ. App. 1940).

1. Production Payment. At its simplest, a production payment owner has nothing more than a contract right to payment. As one commentator has suggested it could be argued that this right is an Article 9 general intangible or account receivable rather than real property. Ryan, "Effect of the Uniform Commercial Code on Oil and Gas Transactions", 18th Annual Inst. on Oil and Gas Law and Taxation, 365, 416-422 (1965). Barkley Clark in his Article 9 treatise, however, suggests that treating a production payment as an Article 9 interest creates unnecessary confusion. See B. Clark, "The Law of Secured Transactions", §13.2(3) ("B. Clark"). In Davis v. Lewis, 100 P.2d 944 (Okla. 1940), the Oklahoma Supreme Court held that an assignment of production payments also constituted a contract relating to real estate under the Oklahoma recording statutes. Notwithstanding this classification, Kuntz notes that production payments can be classified as either royalties or excess (bonus) royalties under oil and gas law. Kuntz, §15.1, P. 432. Different treatment can result from this dichotomy. For example in American Oil & Refining Co. v. Cornish, 49 P.2d 81 (Okla. 1935) the Oklahoma Supreme Court found that a production payment was not "property"
for the purposes of a constitutional property tax exemption. No definitive classification cases involving production payments for Article 9 purposes have been found by this author.


E. Classification of Extracted Oil and Gas.

Kuntz states that "although there are differing views regarding the character of ownership of oil and gas as they reside in the earth, there is uniformity in the conclusion that once oil and gas is extracted from the earth, it becomes tangible personal property...." *Kuntz*, §2.5. *Shreveport - El Dorado Pipe Line Co. v. Bennett*, 290 S.W. 929 (Ark. 1927); *Carpenter v. Shaw*, 272 P. 393 (Okla. 1928) and *Continental Supply Co. v. Marshall*, 152 F.2d 300 (10th Cir. 1945); and *Phillips Petroleum Co. v. Mecom*, 375 S.W. 2d 335 (Tex. Civ. App. 1964). For the purposes of Article 9, extracted oil and gas may be either inventory or accounts.

F. Types of Oil and Gas Contracts which may be Impacted by the U.C.C.

Numerous types of contractual arrangements can be made in connection with oil and gas transactions. These include options to purchase mineral or leasehold interests, contracts for the transfer of interests in oil and gas, contracts for the future execution of a lease, leases, operating agreements, service contracts, licenses, long term gas and/or oil purchase/sale
contracts, spot market purchase/sale contracts, mortgages of oil and gas interests, and collateral and other assignments of interests. Article 9 affects mortgages, collateral assignments and other agreements (e.g. operating agreement provision granting a lien on a signatory's oil and gas interests) purporting to create security interests.

Although Article 2's impact may be greater on oil and gas law, this outline only considers the applicability of Article 2 to (1) oil and gas leases and (2) oil and gas purchase/sale contracts. To do otherwise may leave the reader wondering "will it end." In any event, this applicability analysis is the same for other types of oil and gas agreements.

II. Applicability of Article 2 to Oil and Gas Leases and Purchase/Sale Contracts.

In considering whether Article 2 applies to oil and gas leases and purchase/sale contracts, the question is whether such agreements cover "transactions in goods." §2-102.

A. Oil and Gas Leases as Transactions In Goods.

Before beginning this discussion, the author cautions that almost no case law deals directly with this issue. Following are the few reported cases which have considered whether oil and gas leases are covered by Article 2.

1. After Extraction. Extracted oil and gas are "goods" within the meaning of Article 2. §2-105. *Amoco Pipeline Co. v. Admiral Crude Oil Co.*, 490 F.2d 114 (10th Cir. 1974) (Oil) and cases annotated in 4 ALR 4th 912 (1981 ed.). The real question is whether oil and gas are goods before extraction.

2. Cases Dealing with Oil and Gas Leases as Transactions In Goods Prior to Extraction.

   a. Leases Are Not Transactions In Goods. In *Casper v. Neubert*, 489 F.2d 543 (10th Cir. 1973) (appealed from W.D. Okla.) the owner of undivided interests in several oil and gas leases sold his rights to a third party who subsequently
defaulted in payment. The trial court denied the owner's claim for a vendor's lien in favor of "one who sells real property" (42 Okla. Stat. §26) holding that oil and gas leases are not "real property" within the meaning of Oklahoma's vendor lien statute. Reversing the trial court, the Court of Appeals concluded that the vendor lien statute did apply to the sale of oil and gas leases. In part, this conclusion was based on Oklahoma's concept of an oil and gas lease as an interest in land. But the court went further, relying on §2-105(7) and §2-107(1) to find that unextracted oil and gas were not goods and that Article 2's vendor lien thus did not apply. Since the U.C.C.'s vendor lien did not apply, the court reasoned that the real property lien must apply, almost by default. Neubert is generally cited for the proposition that an oil and gas lease is not a transaction in goods within the meaning of Article 2. This general rule, however, is too broad. Neubert actually addresses the question of whether or not the sale of an oil and gas lease is an Article 2 transaction in goods, not whether or not an oil and gas lease is a transaction in goods.

In Comptroller of the Treasury v. Shell, 64 Md. App. 252, 500 A.2d 315 (1985), the Maryland Court of Appeals considered the classification of oil and gas leases in connection with a corporate income tax dispute between Shell and Maryland. Finding that royalties paid under oil and gas leases were "gross rent" for the purposes of deductions taken by Shell against its taxable income, the Maryland Appeals Court cited the following cases for the proposition that oil and gas leases are not transactions in goods:

(1) Burnet v. Harmel, 287 U.S. 103 (1932) Deciding whether lease bonus and royalty payments were ordinary income or capital gain the United States Supreme Court stated: "Leases would not generally be described as a 'sale' of the mineral content of the soil... nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas."
(2) Kiser v. Eberly, 88 A.2d 242 (1952): “Notwithstanding considerable real or apparent conflict in the decisions as to the nature of [the substantive] rights [that pass under an oil and gas lease] all of the cases . . . hold that an oil and gas lease conveys an interest in or concerning land.” Id. at 246.

b. Oil and Gas Leases Are Analogous to Article 2 Transactions in Goods. The concurring opinion in McGinnis v. Cayton, 312 S.E.2d 765 (W. Va. 1984) reaches the broad conclusion that the U.C.C. might apply by analogy to oil and gas leases. The case considered an 1893 oil lease which provided $100 per year to lessor for all gas production but a 1/8th royalty on oil production. Following a deepening of the original well, significant amounts of gas were collected. The lessor brought an action to reform the lease's gas payment provision to reflect a 1/8th royalty. Reversing the trial court's denial of reformation, the West Virginia Supreme Court held that under certain circumstances reformation might be appropriate. In a concurring opinion, J. Harshbarger argued that broad U.C.C. remedial rights were available to the lessor:

"Gas and oil contracts are construed and interpreted by courts in the same general manner as other contracts. One would be blind to pretend that they are anything but business contracts that tangentially involve aspects of real property law. They are closer to contracts for the sale of goods than typical property leases." Id. at 772.

The United States Court of Appeals, Fifth Circuit imposed Article 2 rules dealing with passage of title ($2-401[1]), quantity ($2-105[4]) and contract quality specifications ($2-501[1]) in Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 231-32 (5th Cir. 1984) when interpreting the relationship between lease royalty clauses and a gas purchase contract. Although this case is not directly on point, the Court clearly interpreted the lease royalty clause
using U.C.C. concepts. This result followed because the gas purchase contract and lease royalty clause were so intertwined.

2. Are Unextracted Oil and Gas "Goods" under Article 2. Assuming a lease is most probably an Article 2 "transaction", C.f. Burnet v. Harmel, 287 U.S. 1-3 (1932), the question is whether unextracted oil and gas are "goods" within the meaning of Article 2. As suggested by Neubert, this issue is controlled by §§2-105(1) and 2-107(1).

a. §2-105(1). §2-105(1) defines goods as follows:

"Goods" means all things (including specially manufactured goods) which are moveable at the time of identification to the contract for sale . . . "Goods also includes . . . other identified things attached to realty as described in the section on goods to be severed from realty ($2-107).

Based on this emphasized language, Comment 1 to §2-105(1) recognizes that §2-107 controls "contracts to sell . . . minerals . . . to be removed from the land . . . ." Before considering §2-107(1), however, it is important to first note that §2-105's definition of goods is totally consistent with unextracted oil and gas being treated as goods, if the point of identification to the contract occurs upon extraction (Note Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 234 (5th Cir. 1984) equates identification under §2-105 with bringing the oil and gas to the surface): (1) §2-105(2) permits a "present sale of future goods or any interest;" (2) §2-105(3) allows "sale of a part interest in existing identified goods;" and (3) §2-105(4) states that an "undivided share in an identified bulk . . . is sufficiently identified to be sold although the quantity of the bulk is not determined."

b. §2-107(1): §2-107(1) expressly deals with goods to be severed from realty and provides:

A contract for the sale of minerals or the like, including oil and gas . . . is a contract for the sale
Comment No. 1 to §2-107(1) focuses on the emphasized language stating that "If the buyer is to sever, such transactions are considered contracts affecting land. . . ." To the extent oil and gas leases resemble a sale, then the lessee is the "buyer" and, as such, it is the lessee or its assign who will most probably extract the oil and gas. Thus, the result of Casper v. Newberry. This analysis does not necessarily mean that Article 2 is inapplicable to oil and gas leases, however. Imaginative lawyering may help convince a court to apply Article 2 provisions and principles into oil and gas leases.

3. Arguments for Treating Oil and Gas Leases as "Transactions in Goods." Before considering these theories, it is important to recognize that even if an oil and gas lease is a transaction in goods, it is not a "contract for sale." A lessor does not sell his goods and lease payments do not resemble sale proceeds. Burnet v. Harmel, 287 U.S. 103 (1932). Following are some arguments which parties who want to apply Article 2 to oil and gas leases might present:

a. Working Interest Held by Lessor. Generally, lessors do not own working interests in oil and gas leases. However, in cases where lessors obtain such interests, then such lessors would be responsible for severing oil and gas from the realty. As noted, §§2-105(2), (3) and (4) are consistent with owning a percentage undivided share of the whole amount of goods. This is the type of interest held by a working interest owner. By analogy, a lessor is like a seller and, thus, it can be argued that §2-102(1) has also been satisfied. The result being that the unextracted oil and gas are goods and the lease, a transaction in goods.

b. By Analogy. Cayton suggests that Article 2 be applied to oil and gas leases by analogy. New Article 2A codifies this approach for non-oil and gas leases. This approach
has long been followed by courts in other areas, with its widest historic application in equipment lease transactions. KLPR TV, Inc. v. Visual Electronics Corp., 465 F.2d 1382 (8th Cir. 1972) (applying Arkansas law); John Deere Leasing Co. v. Blubaugh, 636 F. Supp. 1569 (D. Kan. 1986); Sawyer v. Pioneer Leasing Corp., 244 Ark. 493, 428 S.W.2d 46 (1968); Pacific American Leasing Corp. v. S.P.E. Bldg. Systems, Inc., 730 P.2d 273 (Ariz. App. 1986); and Smith v. Sharpensteen, 13 UCC Rep. 609 (Okla. App. 1973) rev'd on other grounds 521 P.2d 394 (Okla. 1974). c.f. Allen v. Ortho Pharmaceutical Corp., 387 F. Supp. 364 (S.D. Tex. 1974) ("it is axiomatic that in order for Article 2. . . to apply, it is necessary that a sale. . . form the basis for the cause of action.") By similar reasoning, courts have also applied portions of Article 2 to franchise and distributor agreements, which only peripherally deal with goods. Loos & Dilworth v. Quaker State Oil Refining Corp., 500 A.2d 1155 (Pa. Super. 1985) (applying an obligation of good faith by analogy); Corensweet, Inc. v. Amana Refrigeration, Inc., 549 F.2d 129 (5th Cir. 1979); and Zapatha v. Dairy Mart, Inc., 381 Mass. 284, 408 N.E.2d 1370 (1980). In making such an analogy, the courts have looked to the underlying character of the entire transaction, and whether its essence is for the provision of goods from one party to another. Sally Beauty Co., Inc. v. Nexxus Products Co., Inc., 801 F.2d 1001 (7th Cir. 1986) (applying Texas law). No doubt, extracted oil and gas are goods under the U.C.C. Thus, oil and gas leases are the first agreements in a chain which ultimately leads to the sale of the oil and gas goods to third parties. Additionally, lessors usually reserve interests in the resulting income streams generated by sale of the severed oil and gas. But ultimate sale only occurs after exploration, drilling, operating agreements and separate sale contracts between working interest owners, or their nominees, and purchasers. Because of this remoteness, courts should be careful in applying Article 2 by analogy. In similar situations courts have recognized important limits on reasoning by analogy:
"Reasoning by analogy does not require us to apply Article 2 into a lease; rather we need apply only those provisions which are sufficiently analogous." Glenn Dick Equipment Co. v. Galey Constr., Inc., 97 Idaho 216, 541 P.2d 1184 (1975) (equipment lease).

4. Oil and Gas Sale Contracts. Given the previous analysis of §§2-102, 2-105(1) and 2-107(1) it is not surprising that contracts for the sale of extracted oil and gas are uniformly held to be contracts for sale under the U.C.C. Amoco Production Co. v. Western Slope Gas Co., 754 F.2d 303 (10th Cir. 1985); Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984); Pennzoil Co. v. Federal Energy Regulatory Commission, 645 F.2d 360 (5th Cir. 1981); Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114 (10th Cir. 1974); Columbia Gas Transmission Corp. v. Larry H. Wright, Inc., 443 F. Supp. 14 (S.D. Ohio 1977); American Exploration Co. v. Columbia Gas Transmission Corp., 40 U.C.C. Rep. 1647 (S.D. Ohio 1985); K.N. Energy, Inc. v. Great Western Sugar Co., 698 P.2d 769 (Colo. 1985); Pioneer Hi Bred Corn Co. of Ill. v. Northern Ill. Gas Co., 16 Ill. App. 3d 638, 306 N.E.2d 337 (1973); and Sunflower Elec. Corp., Inc. v. Tomlinson Oil Co., Inc., 638 P.2d 963 (Kan. App. 1981); and 4 ALR 4th 912 (1981 Ed.). As with oil and gas leases, however, sale/purchase contracts must provide that the oil and gas be severed by the seller to meet §2-107(1)'s test. Otherwise, they will be treated as a sale of real property. In practice, most gas contracts provide that the seller will "sell and deliver" the gas to buyer. Legg & Dacy, "The Applicability of the Uniform Commercial Code to Natural Gas Contracts" 36 Oil and Gas Tax Quarterly Vol. 3, 67 (1987) and Oskey Gasoline and Oil Co. v. OKC Refining, 364 F.Supp. 1137, 1141 (D. Minn. 1973).

III. Impact of Article 2 on Oil and Gas Leases and Sale/Purchase Contracts.

If a contract is directly subject to Article 2, then it is subject to all of its rules. If Article 2 is applied by analogy, the court may limit its applicability. Again to limit its scope,
this outline will only consider the possible impact of certain sections of Article 2, including (1) formation, (2) interpretation, (3) remedies and (4) certain defenses.

A. Formation. While there are parallels between Article 2 and common law contract principles, it has been said that Article 2's "provisions on the formation of contracts for the sale of goods have... radically altered sales law... In most fundamental terms (Article 2) expands our conception of contract. It makes contracts easier to form and it imposes a wider range of obligations than before." White & Summers, "Uniform Commercial Code", §1-1 (1980 Ed.). Unlike the common law, Article 2 presumes that there is a basic disposition towards making business arrangements into legally enforceable contracts, even through certain elements required by common law are missing. For example, §2-204(1) says "a contract, for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." Article 2 goes even farther by providing so-called gap-fillers which ensure a basis for finding a contract, which might otherwise fail for indefiniteness. Following are some examples of these provisions which may have particular application to oil and gas related agreements.

1. Indefiniteness. §2-202(1) permits a contract "even though one or more terms are left open... if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy." Thus, a contract may be found even though there are "missing terms needed for performance, open price, remedies and the like." Comment to §2-204.

2. Writing. A contract may be evidenced by any writing which is "sufficient to indicate a contract for sale has been made." §2-201(1). Consequently, not all terms need be in writing.
3. **No Price Term.** Parties may intend to be bound by an agreement, even though price is not settled. In such cases, if (a) nothing is said as to price, or (b) the price is to be fixed by the parties and they cannot agree, or (c) the price is fixed according to some market or other standard set by a third party and it is not so set or recorded then the price is the "reasonable price at the time of delivery". The parties may also agree that the price be fixed by the buyer or seller in good faith. §2-305(1). In *North Central Airlines v. Continental Oil Co.*, 547 F.2d 582 (D.C. 1978), the price for aviation fuel was fixed at posted prices set by a third party. When that party changed the method, the contract no longer set a definite price. Relying on §2-305, the Court set the price at a "reasonable" level. A similar result may follow with deregulated gas under N.G.P.A. because provisions tied to regulated prices will no longer be applicable. To the extent a contract price redetermination clause does not control, the U.C.C. will set the price at a "reasonable" level.

4. **Output/Requirements Contracts.** §2-306(1) permits quantity terms measured by actual output or requirements as they may occur in good faith. Since extracted oil and gas are goods within the meaning of the U.C.C., any type of arrangement whereby a third party is in charge of selling such oil and gas on behalf of working interest owners, may be subject to §2-306(2). Such relationships often occur under operating agreements. Additionally, a gas contract may be viewed as an output/requirements contract, which imposes a standard of good faith on both parties to the contract.

5. **Merchants under the U.C.C.** §2-104 defines merchant as a "person who deals in goods of the kind or otherwise by his occupation, holds himself out as having knowledge or skill peculiar to the practices or good involved in the transaction or skill may be attributed by his employment of an agent... or other intermediary who by his occupation holds himself out as
having such knowledge or skill." §2-104's definition of merchant captures a considerably broader class than the man on the street might think. The "dealing in goods" requirement includes people like the jeweler, hardware store owner, furniture salesmen and others selling from inventory while the second, dealing with occupation, includes specialties such as electricians, plumbers, carpenters, boat builders, landmen and the like. The definition of §2-104 is so broad that it is most likely that oil and gas companies, pipeline companies, producing companies and the like are well within its scope. Even individuals who own a significant number of working interests and are involved in the sale of the oil and gas attributable to those working interests may be merchants. See Columbia Gas Transmission Corp. v. Larry H. Wright, Inc., 443 F.Supp. 14 (S.D. Ohio 1977) (Applying the U.C.C. definition of merchant). This classification imposes higher standards in contractual relationships. Consider a spot market example discussed in a recent article dealing with the U.C.C.'s impact on oil and gas law. On the spot market it is not unusual for a party to make "brief one paragraph written offers to buy or sell gas." Legg & Dacy, "The Applicability of the Uniform Commercial Code to Natural Gas Contracts", 36 Oil & Gas Tax Quarterly Vol. 3, 67, 73 (1987). If the parties are classified as merchants, it is quite likely that such offers result in binding contracts as follows:

a. Indefiniteness. As previously noted, a contract will not fail for indefiniteness despite the fact that one or more terms are left open. §§2-202(1) and 2-204(3). See Columbia Gas Transmission Corp. v. Larry H. Wright, Inc., supra and Amoco Production Co. v. Western Slope Gas Co., 754 F.2d 303 (10th Cir. 1985) (both applying the U.C.C.'s parole evidence rule).

b. Statute of Frauds. Under the U.C.C., a contract for the sale of goods for $500 or more must be evidenced by a writing "sufficient to indicate that a contract for sale has been made between the parties and signed by the party against
whom enforcement is sought or by his authorized agent...." §2-201(1). However, a different rule applies to merchants. Between merchants, a written confirmation of an oral contract satisfies this writing requirement unless the other party objects within 10 days after receipt of the confirmation §2-201(2).

c. **Offer and Acceptance.** Between merchants, a definite expression of acceptance of an offer to sell which is sent within a reasonable time operates as an acceptance of a contract, even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional or is sent to the additional or different terms. §2-207(2). If additional terms are proposed to a contract between merchants, they become part of the contract unless: (i) the offer expressly limits acceptance to the terms of the offer; (ii) they materially alter the offer; or (iii) notification of objection to them has already been given or is given within reasonable time after notice of them is received. §2-207. This is different from the non-merchant rule and results in easier contract formation with the U.C.C. filler terms supplying the remainder of the terms.

d. **Warranties.** The implied warranty of merchantability under §2-314 will arise because the seller is a merchant. Pioneer Hi Bred Corn Co. of Ill. v. Northern Ill. Gas Co., 16 Ill. App. 3d 638, 306 W.E.2d 332 (1973) (failure to maintain a certain gas pressure as a breach of warranty).

e. **Good Faith.** A merchant's standard of good faith under §2-103(1)(b) includes honesty in fact and an observance of reasonable commercial standards of fair dealing in the trade, an objective standard provable by extrinsic evidence. Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114 (10th Cir. 1974) (failure to take gas constituted a breach of good faith); and Columbia Gas Transmission Corp. v. Larry H. Wright, Inc., supra.
f. **Responsibilities of Merchant Buyers to Follow Seller Instructions.** §2-327(1)(c), §2-603 and §2-605 presents special responsibilities of merchant buyers to follow seller's instructions.

g. **Contract Modification.** As between merchants, a contract which excludes modification or rescission except by signed writing, can be satisfied on a form supplied by a merchant simply signed by the other party.

When taken together with the price and quantity fillers of §2-305 and §2-306, these sections mean that parties dealing in the spot market must be wary when dealing in confirmations, proposals and counterproposals lest they find themselves having made a binding contract.

**B. Interpretation.** Most courts generally state that the paramount issue in contract interpretation is determining the party's intent at the time of making the contract. Penzoil v. F.E.R.C., 645 F.2d 360 (5th Cir. 1981); and Oskey Gasoline & Oil Co. v. OKC Refining, Inc., 364 F.Supp. 1137 (D.C. Minn. 1973). Under the common law and many state statutes, the parole evidence rule and statute of frauds generally require that writings be treated as a complete expression of an agreement and do not permit extrinsic evidence to explain the terms. The U.C.C. restricts this rule and comes closer to assuming that a writing is not a complete expression of the agreements between the parties, even if there is no ambiguity. Thus §2-202 provides that, although the final terms of an agreement may not be contradicted by evidence of any prior agreement or of a contemporary oral agreement, they may be explained or supplemented by course of dealing, usage of trade, course of performance and even evidence of consistent additional terms unless the court finds the writing to have been intended as a complete and exclusive statement of the terms of the agreement. This is true even where the contract is not ambiguous. Paragon Resources v. Natural Fuel Gas Dist., 695 F.2d 991 (5th Cir.)
Nonwritten course of dealing, usage of trade and course of performance may be very critical in interpreting oil or gas sale/purchase contracts.

1. **Course of Dealing.** A course of dealing "is a sequence of previous conduct between the parties... which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." (emphasis added) §1-205(1). A course of dealing arises prior to the contract and can be used to supplement an agreement even where there is no ambiguity. The express terms of the agreement and an applicable course of dealing should be construed as being consistent with each other when possible, "but when such construction is unreasonable, express terms control both course of dealing and usage of trade and course of dealing controls usage of trade." §1-205(4). Course of dealing can be critical because it has been said that prior dealings are the "best possible guide" to the parties true intent with regard to the contract. K.N. Energy, Inc. v. Great Western Sugar Co., 698 P.2d 769 (Col. 1985) and Amoco Production Co. v. Western Slope Gas Co., 754 F.2d 303 (10th Cir. 1985).

2. **Trade Usage.** "A usage of Trade is any practice or method of dealing having such regularity of observance at a place, vocational or trade as to justify an expectation that it will be observed with respect to the transaction in question." §1-205(2). Like course of dealing, trade usage arises before the contract and is a question of fact. §1-205(2).

3. **Course of Performance.** Unlike (1) and (2) above "course of performance" is based on relevant conduct following execution of the contract. It has been noted that "the U.C.C. looks to the actual performance of a contract as the best indication of what the parties intended these terms to mean. Course of performance... aids interpretation whenever one party accepts repeated performance by the other party with knowledge of the nature of performance and an opportunity to object to it, but
acquiesces or does not object." Paragon Resources v. Natural Fuel Gas Dist., 695 F.2d 991 (5th Cir. 1983) and K.N. Energy, Inc. v. Great Western Sular Co., supra.

4. Seller Remedies under the U.C.C. U.C.C. remedies for breach, although consistent with the common law, are very broad. In the current gas market, where there exists an over-deliverability of natural gas and depressed prices, the terms of natural gas sale/purchase contracts are not being honored. In such situations reluctant buyers may force sellers to look to their U.C.C. remedies. Buyers have a similar broad range of remedies, but they are beyond the scope of this outline. For buyer remedies readers should consult §2-711-2-717. See e.g. Pioneer Hi Bred Corn Co. of Ill. v. Northern Ill. Gas Co., 16 Ill. App. 3d, 306 N.E.2d 357 (1977) (applies the cover remedy of §2-712).

§2-703 provides that upon buyer's breach of contract the seller may: (i) withhold or stop delivery of such goods, (ii) resell and recover damages as provided in §2-706, (iii) recover damages for nonacceptance (or in a proper case, the price); and (iv) cancel. Remedies for nonpayment however, apply only where payment is "due on or before delivery". §2-703. Take or pay provisions are one common form of prepayment found in many gas contracts, which may invoke these remedies.

Generally the U.C.C. will not allow the seller to recover the full purchase price from the buyer for breach of a natural gas contract. In most instances, oil and gas remains in the formation. Under §2-706(1), if goods (such as unextracted oil and gas) are retained by the seller and resold the measure of damages is the difference between the contract price and the price of resale. Where such goods are not resold after repudiation by the buyer, the seller's measure of damages is the contract price less the market price at the time and place for tender. §2-708(1). Certain procedural safeguards also restrict the manner of resale. For example such goods must be sold "in
good faith and in a commercially reasonable manner." §2-706(1). Where the resale is a private sale, the seller must give the buyer reasonable notification of seller's intention to resell the oil and gas to another party. §2-706(3). If the seller profits from such resale, however, the seller is not accountable for such profit. §2-706(6).

In general, sellers may sue for the contract price only if the goods are lost or damaged, which usually does not occur to unextracted natural oil and gas. Further, an action for contract price is applicable only if the goods are "identified to the contract." In Piney Woods Country Life School v. Shell Oil Company, 726 F.2d 225 (5th Cir. 1984), the court stated that "gas underground is future goods; no particular gas is sold until it is identified -- i.e., brought to the surface." As such, natural gas which has not been produced is not "identified to the contract," and therefore the remedy of contract price was not available. Further, §2-709(1)(b) allows the recovery of the contract price only if "the seller is unable after reasonable effort to resell them at a reasonable price or the circumstances reasonably indicate that such effort will be unavailing." In today's current market, it is unlikely that the seller would be able to meet this test although at a very reduced price.

Additionally, the seller should note that the U.C.C. contains specific references to the mitigation of damages and reasonableness. Comment 1 to §1-106 states that the U.C.C. "makes it clear that damages must be minimized." Common law mitigation principles arguably also supplement the U.C.C. through §1-103.

5. Defenses as to Breach of Contract. Most commentators note that U.C.C. defenses are not unique to the U.C.C. and merely incorporate traditional common law remedies and concepts. Hillman, McDonnell and Nickles, "Common Law and Equity under the U.C.C." (1985 ed.). As sellers have recently invoked U.C.C. remedies, buyers have tried to rely on these defenses.
Following is a brief outline of two of the more important defenses.

a. **Unconscionability.** Section 2-302 provides that if a court "as a matter of law finds the contract . . . unconscionable at the time it was made the court may refuse to enforce the contract . . . ." Unconscionability does not mean that a court will refuse to uphold a bad bargain. The underlying reason for a court's refusal to enforce unconscionable contracts is the principle of preventing unfair surprise, not to reallocate the risk due to the superior bargaining power of one party. *Fargo Machine and Tool Co. v. Kearney and Trucker Corp.*, 428 F. Supp. 364, 381 (E.D. Mich. 1977). Thus the basic test of unconscionability is "whether, in light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." Comment 1 to §2-302. Unconscionability is almost always raised in recent take-or-pay litigation. *Madina, McKinsey and Daniel, "Take or Litigate: Enforcing the Plain Meaning of the Take-Or-Pay Clause in Natural Gas Contracts",* 40 Ark. L. Rev. 185, 228-232 (1987) (hereinafter referred to as "Madina, McKinsey and Daniel").

b. **Impracticability.** §2-615 codifies the common law concepts of impossibility and frustration in a commercial impracticability defense. §2-615(a) provides that "delaying delivery . . . by seller . . . is not a breach of his duty under the contract per se unless performance as agreed has been made impracticable by the occurrence of the contingency the non-occurrence of which was a basic assumption on which the contract was made . . . ." Although the U.C.C. speaks of this defense as being available to sellers it has been extended to buyers of gas as well. *International Metals and Chemical Corp. v. Llano, Inc.*, 770 F.2d 879 (10th Cir. 1985) Courts strictly construe the doctrine of impracticability and a showing of mere unprofitability or increased costs is not sufficient to relieve
the contracting party. See Comment 4 of §2-615 and Eastern Airlines, Inc. v. Gulf Oil Corp. 415 F. Supp. 429 (S.D. Florida 1975). Although this defense is available to purchasers of natural gas, it has met only limited success to date. Madina, McKinsey and Daniel at 232-239.

6. Good Faith. Before leaving the Article 2 discussion, it is important to note the U.C.C.'s imposition of a standard of good faith under all U.C.C. contracts and transactions. §1-203. Generally, the U.C.C. term "good faith" only means "honesty in fact in the conduct or transaction concerned." §1-201(19). Arguments have been made concerning how stringent of a standard this is, which to a great extent center around whether "honesty in fact" is an objective or subjective standard. See Hardin, "Equitable and Good Faith Limitations on the Enforcement of Acceleration Clauses" 57 Okla. B.J. 1841 (1986). As previously observed, however, in the case of Article 2 transactions involving merchants, §2-103(b) imposes a higher objective standard of reasonable commercial standards of fair dealing. When combined with the fact that many courts recognize an affirmative cause of action for breach of the duty of good faith, this objective standard can become very meaningful to litigants. Although oil and gas law has in certain instances imposed a common law standard of good faith, the standard is not so high or exact as that of Article 2. Kuntz §§ 474 (in commencement of a well) and 48.3 (pooling). For numerous cases dealing with the issue of good faith affirmative actions and defenses see "Lender Liability Litigation", PLI Pub. #A4-4202 (1987).

IV. Impact of Article 9 on Oil and Gas Leases.

It has been noted that oil and gas financing is "a strange world of its own." Woodward v. Wright 266 F.2d 108, 115 (10th Cir. 1959). As previously discussed, Article 9 usually suggests that the law of real estate mortgages should govern mineral
interests prior to extraction. However, like many generalities, it is wise to consider some possible exceptions to the rule.

A. Direct Applicability of Article 9 to Oil and Gas Leases.

1. Oil and Gas Leases Themselves as Article 9 Personal Property. As noted in Sections II(C) and (D) of this outline, derivative interests created under oil and gas leases may sometimes be considered as personal property by applicable state law. Although Arkansas, Oklahoma and Texas appear to treat oil and gas interests as real property not subject to Article 9, there are at least two arguments available which may create uncertainty by indicating applicability of Article 9 in some instances.

   a. Derivative Interests as Interests in Personal Property. Section II(D) of this outline suggests that production payments, net profits interests and other derivative oil and gas leasehold interests which might be created from time-to-time, are sometimes personal property for the purposes of state law. As such, they are clearly within the scope of §9-102(1)(a) and most likely should be treated as general intangibles under §9-106.

   b. Treating the Lease Itself as Being Subject to Article 9. In Citicorp v. Fremont National Bank, 738 P.2d 29 (Colo. App. 1987), the debtor assigned the secured party the right to receive the proceeds of an installment loan sale contract, giving the secured party possession of the sale contract documents. The Court found that Article 9 applied to the collateral assignment, describing the land sale contract as "realty paper" which was itself personal property subject to the U.C.C. Notwithstanding §9-104(j) which states that Article 9 does not apply to the creation of an interest in real estate, Comment 4 to §9-102(3) supports the Colorado Court's conclusion, giving the following example:
The owner of Blackacre borrows $10,000... and secures his note by a mortgage on Blackacre. (Article 9) is not applicable to the creation of the real estate mortgage. However, when the mortgagee in turn pledges this note and mortgage to secure his own obligation to X, (Article 9) is applicable to the security interest thus created in the note and the mortgage.

The example is directly on point to the facts in Citicorp and few would argue with the Court's result. But the example and its use in Citicorp casts doubt on whether Article 9 directly applies to oil and gas leases.

Oil and gas leases create rights to receive an income stream similar to that created by the Citicorp installment land sale contract. Oil and gas leases are themselves pieces of paper which are personal property. Oil and gas leases relate to property that will be treated as personal property from the moment of extraction. Finally, as seen before in this outline, many courts (particularly Oklahoma) already treat oil and gas leases as personal property for certain purposes, even before extraction. These similarities certainly imply that Article 9 should cover rights granted in oil and gas leases. While it is possible that a court will apply Citicorp by distinguishing between the lease itself (excluded from Article 9 by §9-104[5]) and a security interest in the rights under the lease (Comment 4 to § 9-102), certain distinctions between the nature of oil and gas leases and land sale contracts and the historical treatment of oil and gas leases make this result unlikely.

Unlike Citicorp's land sale contract, §9-104(j) expressly excludes "interests in... real estate, including a lease... thereunder." Second, as noted in a recent commentary on Citicorp, a land sale contract is subject to the traditional common law doctrine of equitable conversion which converts the seller's interest into personal property. Harrell and Dancy, "Oil and Gas Financing Under Uniform Commercial Code Article 9", Okla. L. Rev. _____ (to be published in 1988). This is not true of oil and gas leases. Finally, and perhaps most
importantly, courts in Arkansas, Oklahoma and Texas have all held that mortgages on oil and gas leases are subject to real estate mortgage filing and attestation rules. See Sections I(C)(1)-(3) of this outline supra. It will be very difficult to change that historic approach. See also Ingram v. Ingram, 521 P.2d 254 (Kan. 1974) which holds that an oil and gas lease pledged as collateral is not personal property subject to Article 9. This case is particularly relevant to Oklahoma because Kansas, like Oklahoma, generally considers an oil and gas lease as "profit a pendre" or "incorporeal hereditament."

   c. Oil and Gas Leases as Security Devices. If an oil and gas lease (or derivative interest such as a production payment) is intended to secure payment of a note, then the lease itself may be deemed a mortgage, regardless of its form. See e.g. Coast Bank v. Minderhout, 392 P.2d 265 (Cal. 1964). As such, the note and lease/mortgage would be subject to Article 9. §§9-304, 9-305, 9-308 and 9-309. In such a situation, Citicorp's reasoning clearly applies.

   d. Precautions. Because of the preceding discussion, the author believes that creditors using oil and gas interests as collateral security should make a double filing as a mortgage and under a U.C.C. financing statement (central filing). This practice does no harm and is prudent given the uncertainties in this area.

   e. Second Level Security Interests. The previous discussion should not mislead the reader concerning second level security interests. For example, the partnership interest of a person in an oil and gas limited partnership program is an Article 9 general intangible. Comment 4 to Section 9-102(3).

2. Interests in Extracted Oil and Gas. Once extracted, there is no doubt that oil and gas are considered personal property subject to Article 9. Continental Supply Co. v. Marshall, 152 F.2d 300 (10th Cir. 1945) and §9-105(1)(h).
Generally, immediately upon extraction minerals become inventory under §9-109(4), since they are held by a person who "holds them for sale." Section 1-201(9) (amended in 1972) makes it clear that working interest owners who are selling their oil and gas fit within the category of a "person who holds for sale" by stating that "all persons who sell minerals or the like (including oil and gas) at wellhead... shall be deemed to be persons in the business of selling goods of that kind." As inventory, a security interest must be perfected in accordance with §§9-401(1) (place of filing), 9-103 (choice of applicable law) and 9-402. (Note, that Oklahoma and Texas have non-uniform amendments).

After becoming inventory, the extracted oil and gas again changes form when sold. Gas sold into a pipeline subject to a contract instantaneously becomes "accounts" under §9-106 as a right to payment for goods sold. In turn, these accounts will ripen into identifiable cash proceeds in the form of checks drawn by the pipeline purchaser as determined by division orders. This same reasoning is not as true for crude oil since division orders do not create legal enforceable obligations of the purchaser to buy.

B. Choice of Law and Filing.

It is beyond the scope of this outline to discuss the numerous issues and questions which arise in connection with these Article 9 filings. However, the reader should be aware of the U.C.C.'s choice of law provisions. Under §9-103(5) "perfection and the effect of perfection or nonperfection of a security interest which is created by a debtor who has an interest in minerals or the like (including oil and gas) before extraction and which attaches thereto as extracted, or which attaches to an account resulting from a sale thereof at the wellhead or minehead are governed by the law (including conflict of laws rules) of the jurisdiction wherein the wellhead or minehead is located." Thus, as oil and gas is extracted the
perfection rules which govern that oil and gas are based on the location of the wellhead. Where the gas ultimately is sold is not relevant. Arkansas, Oklahoma and Texas have adopted this provision.

V. Conclusion. Traditionally, courts have not applied the provisions of U.C.C. Articles 2 and 9 directly to oil and gas leases or even their derivative interests. No question exists, that these articles control important related contracts, such as oil and gas purchase/sale agreements. Article 2's more lenient contract formation and interpretation rules and liberal remedies, however, mean that imaginative attorneys will search for ways to impose the U.C.C. directly or by analogy onto oil and gas lease transactions. Similarly, debtor/creditor lawyers looking for ways to challenge the priority of oil and gas mortgages may argue Article 9's direct applicability to oil and gas leases and their derivative interests. This area of the law is relatively undeveloped but may see more activity because of (i) the attractive features of the U.C.C., (2) inherent uncertainties raised by oil and gas law and (3) economic/litigation pressures in oil and gas states.