



The Legal and Business Risks of Developing an Oil and Gas Leasehold Interest Without Obtaining Lien Subordination Agreements

Kimberly Luff Wakim
Justin C. Harding
Thorp Reed & Armstrong
Pittsburgh, Pennsylvania

Synopsis

Table with 2 columns: Section Number and Page Number. Includes sections like Introduction, Types of Liens, Establishment of Priority Status, Prior Liens, Oil and Gas Operations, and Ramifications of Foreclosure.

§ 2.07. Title Curative for Prior Liens 70
 [1] — Satisfaction on the Record of Lien Obligations
 Previously Fulfilled. 70
 [2] — The Subordination Agreement. 71
 [3] — The Non-Disturbance Agreement. 75

§ 2.08. Business Curative of Prior Liens. 77
 [1] — Purchase Lienholder’s Position. 77
 [a] — Subrogation. 77
 [b] — Redemption. 79
 [2] — Use of Lease Royalties. 80
 [3] — Mandatory Notification by Lessor to Lessee
 of Lien Debt Service or Default. 81

§ 2.09. Summary and Conclusion. 81

§ 2.01. Introduction.

Imagine you are the best friend and attorney of Blackbeard – no, not the pirate, but a descendant of the very Blackbeard that used to terrorize the eastern seaboard. Blackbeard has grown tired of life in Texas, and has decided to take a Tom Sawyer-like voyage on the Mississippi and its tributaries in search of a better life. In Kentucky, Blackbeard finds what he is seeking, a scenic and peaceful parcel of land where he can avoid all the people who flee in terror after hearing his name. Blackbeard purchases the land and sets out to build his dream house. He obtains a loan from FreeMoney Bank, grants FreeMoney Bank a mortgage on his land to secure the loan and hires a number of contractors to build his dream home. One of the last things in Blackbeard’s home building process is the drilling of a water well. Blackbeard drills deep, because his land is well above the water table. However, instead of finding water, Blackbeard finds oil and gas. OilCo is very excited upon hearing the news, and convinces Blackbeard to enter into an oil and gas lease with OilCo.

Blackbeard is overjoyed at the prospect of all the extra royalty income from the oil and gas lease, and adds a new wing to his home. The new wing is funded by a loan from Second Bank, which loan is secured by a mortgage on Blackbeard’s land, and more contractors come in to build. While things

appear to be rosy, Blackbeard is often inattentive to his bills and fails to pay his taxes, both mortgages, and both sets of contractors who built his home and the new wing. Blackbeard and OilCo now have all kinds of problems, including the fact that FreeMoney Bank is displeased that they were not consulted prior to Blackbeard’s entering into the oil and gas lease with OilCo.

This example highlights many of the issues that an oil and gas lessor and lessee may face. Assuming proper recordation of their interests in the appropriate recording offices, it appears that FreeMoney Bank and the first group of contractors (via mechanics’ liens) have priority over the OilCo oil and gas lease, which if properly recorded, should have priority over the mortgage of Second Bank and possibly (depending on state law) the second set of contractors that filed mechanics’ liens against Blackbeard’s land. As a general rule, a properly conducted foreclosure proceeding with respect to a lien that is recorded prior to an oil and gas lease will divest the rights of the lessee under the oil and gas lease and all other interests in the real estate that are subordinate to the lien that is being foreclosed upon.¹

This chapter discusses what Blackbeard and OilCo should have done, or still can do, in order to preserve OilCo’s oil and gas lease. In order to properly analyze issues pertaining to the subordination of legal rights and interests to an oil and gas lease, a review of implicated rights and interests are necessary.

§ 2.02. Types of Liens.

A lien has been defined as “a claim, encumbrance, or charge on property for payment of some debt, obligation or duty.”² A lien can be created in one of two manners: through statute or through contract.³

¹ See 4 Eugene Kuntz, *The Law of Oil and Gas* § 52.3 (1990); State *ex rel.* Comm’rs of Land Office v. Reynolds, 206 P.2d 184 (Okla. 1949).

² *Black’s Law Dictionary* 922 (6th ed. 1990)(citing Sullins v. Sullins, 396 P.2d 886, 888 (Wash. 1964)).