

INSIGHTS

## Third Circuit Holds that Automatic Perfection Provisions Are Not So Automatic

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Close to ten years have passed since the filing of the Chapter 11 cases of Tulsa, Oklahoma-based SemCrude L.P., but this week, the Third Circuit Court of Appeals affirmed a 2015 district court ruling that resolved a dispute between oil producers and downstream purchasers over the perfection and priority of interests in oil sold by SemCrude L.P. and its affiliates. The Third Circuit's holding in *In re SemCrude L.P.*, --- F.3d ---, 2017 WL 3045889 (3d Cir. July 19, 2017), affirmed the earlier bankruptcy and district court rulings that the downstream purchasers took oil purchased from SemGroup, free and clear of the oil producers' liens because the purchasers were "buyers for value." The Third Circuit's decision serves as a stark warning for oil producers to not rely on automatic perfection provisions of state law and take efforts to put subsequent purchasers on actual notice.

SemGroup filed for Chapter 11 in 2008. SemGroup and its subsidiaries provided midstream oil services whereby SemGroup purchased oil from oil producers and resold that oil to downstream purchasers. SemGroup also traded oil futures with two of its downstream purchasers in a trading strategy that ultimately led to SemGroup's insolvency. The downstream purchase agreements provided, in relevant part, that in the case of default, the downstream purchasers could offset the amounts owed to SemGroup by the amount that the SemGroup owed the purchasers for the value of outstanding futures trades. At the time of SemGroup's filing, more than a thousand oil producers were unpaid. The offset feature of the purchase agreements resulted in full recovery to the downstream purchasers, however, the oil producers received only partial payment in the plan of reorganization.

Unhappy with only a partial recovery under the plan, the oil producers brought claims against the downstream purchasers under theories of fraud, priority security interests under Texas and Kansas laws, and implied trust under the Oklahoma Production Revenue Standards Act ("PRSA").

The claims of security interests were entirely rejected by the Court. Texas and Kansas have enacted non-uniform Uniform Commercial Codes with special provisions for owners such as oil producers. In Texas, interest owners have an automatically-perfected security interest in oil produced and the identifiable proceeds related thereto. In Kansas, oil producers are required to file an "affidavit of production" in order to perfect their security interests in the oil. In both jurisdictions, the oil producers' lien extinguishes after the first purchaser sells to a buyer in the ordinary course.

The oil producers had argued that, under the laws of Kansas and Texas, they held automatically perfected security interests in all oil sold to SemCrude and that the downstream purchasers took subject to those security interests. First, the Court held that the oil producers had not perfected the security interests in accordance with the local laws of Delaware and Oklahoma (where the debtors, the first purchaser of the oil, reside). Because Texas and Kansas had adopted Article 9 of the U.C.C., it is the laws of the jurisdiction of the debtor's location that "governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral." U.C.C. 9-301(1).

Second, the Third Circuit held that the downstream purchasers acquired the oil asset without any actual knowledge of the oil producers' interests. Because the downstream purchasers were "buyers for value" or "buyers in the ordinary course" who acquired the oil without any actual knowledge of the oil producers' interests, the downstream purchasers acquired the oil free and clear from any asserted security interest. In short, although Texas and Kansas state law appeared to afford oil producers automatic protection of their security interests, the validity of that security interest turned on perfection in the debtor's locale, and the actual knowledge of the purchaser.

With respect to the oil producers' PRSA claim, the oil producers asserted that they held an implied trust that traveled "perpetually down the stream of commerce . . . [and] whoever possess the oil does so for [the oil producers'] benefit." Under this theory, the downstream purchaser, as alleged trustee, has legal obligations to the oil producer. The Third Circuit, like the bankruptcy and district courts before it, rebuffed the oil purchasers, holding that "this interpretation simply fails the text of the statute" and that "whatever duties PRSA creates, they do not apply to downstream purchasers."

Appellant oil producers' fraud claims hinged on the theory that the downstream purchasers aided and abetted the debtors who allegedly purchased oil without the intention of paying for it. This claim was flatly rejected by the rulings of the bankruptcy and district court, and the Third Circuit found no hallmarks of fraud. Rather, the Third Circuit observed that there existed no evidence that SemGroup "ever intended to avoid paying for oil" or that the downstream purchasers conspired with SemGroup.

In closing, the Court observed that the oil producers "theoretically could have perfected their security interests, traced those interests in the oil that extended to their accounts receivable, and forbade SemGroup from using those accounts as margin collateral for their options trades." However, having failed to take those steps, the oil producers could not look to parties like the downstream purchasers "who took precautions against insolvency . . . [to] act as insurers to those who took none." The effect of any other finding "would be chaos."

Additional analysis of issues arising in the SemCrude L.P. Chapter 11 cases can be found [here](#).