

Approved March 1, 1989
Date

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY

The meeting was called to order by Representative Michael O'Neal at
Chairperson

3:30 ~~xxx~~/p.m. on February 20, 1989n room 313-S of the Capitol.

All members were present except:

Representative Peterson, who was excused.

Committee staff present:

Jerry Donaldson, Legislative Research Department
Jill Wolters, Revisor of Statutes Office
Mary Jane Holt, Committee Secretary

Conferees appearing before the committee:

Ron Smith, Kansas Bar Association
Representative Eugene Shore
Gregory J. Stucky, Southwest Kansas Royalty Owners Association, Wichita
Donald P. Schnacke, Kansas Independent Oil & Gas Association, Wichita

BILL REQUESTS:

Ron Smith, Kansas Bar Association requested the Committee introduce a bill which is a clean-up of the Uniform Commercial Code. This bill is similar to 1987 H.B. 2750.

Representative Jenkins made a motion to introduce the bill requested by the Kansas Bar Association as a Committee bill. Representative Shriver seconded the motion. The motion passed.

Representative Hochhauser explained a bill that would require fingerprinting of persons dealing with pawnbrokers, see Attachment I.

A motion was made by Representative Hochhauser to introduce the bill as a Committee bill. Representative Snowbarger seconded the motion. The motion passed.

Representative Douville explained a bill request that would make the garnishment clearer for people who are paid on a weekly basis and for people who are paid on a monthly basis, see Attachment II.

A motion was made by Representative Douville to introduce a bill amending the garnishment law, as a Committee bill. Representative Solbach seconded the motion. The motion passed.

HEARING ON H.B. 2353 - Oil and gas owners's lien act

Representative Eugene Shore testified H.B. 2353 is the result of concerns statewide for leaseholders of royalties after a producer files for bankruptcy. He said recent failures of independent oil and gas producers and mergers involving large amounts of dollars among major oil and gas producers have created a concern among the thousands of royalty owners in Kansas that perhaps their livelihood may be jeopardized through no fault of their own. H.B. 2353 attempts to address that concern, see Attachment III.

Gregory J. Stucky, Southwest Kansas Royalty Owners Association, testified this bill provides that working interest owners and royalty owners can secure a lien on the leasehold of the nonpaying operator and on their share of the oil and gas, or the sales proceeds thereof, by making the appropriate filing with the clerk of the district court of the county in which the well is located, see attachment IV.

Donald P. Schnacke, Kansas Independent Oil and Gas Association, testified in opposition to H.B. 2353. He said this bill might do more harm than good. Kansas lien law is complex and this bill has a hard time meshing with existing Kansas statutes. The bill also involves impairment of titles. He suggested a statutory declaration that the funds in question are being held as trust funds for the benefit of persons entitled to receive them, see Attachment V.

CONTINUATION SHEET

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY,
room 313-S, Statehouse, at 3:30 ~~am~~ p.m. on February 20, 1989.

The hearing on H.B. 2353 was closed.

The Chairman appointed Representative Walker, Representative Snowbarger and Representative Shriver, as a subcommittee to study H.B. 2353 and report to the Committee.

The Chairman also appointed Representative O'Neal, Representative Jenkins, Representative Douville, Representative Whiteman and Representative Roy as a subcommittee to study the Attorney General's Victims' Rights bills, H.B. 2798, H.B. 2199, H.B. 2200 and HCR 5008.

The minutes of February 9, 1989 were approved.

The Committee meeting was adjourned at 4:30 p.m. The next meeting will be Tuesday, February 21, 1989, at 3:30 p.m. in room 313-S.

HOUSE BILL NO. _____

By

AN ACT concerning pawnbrokers; relating to the fingerprinting of persons dealing with pawnbrokers.

Be it enacted by the Legislature of the State of Kansas:

Section 1. (a) Any pawnbroker licensed under K.S.A. 16-706 et seq., and amendments thereto, shall have one fingerprint on record of any person who deposits or pledges personal property or other valuable things, other than intangible personal property, or who sells personal property on the condition of buying the same back again at a stipulated price.

(b) This section shall be part of and supplemental to K.S.A. 16-706 et seq., and amendments thereto.

Sec. 2. This act shall take effect and be in force from and after its publication in the statute book.

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Attachment I

LAW OFFICES
RONALD W. NELSON
SUITE 300
METCALF STATE BANK BUILDING
COLLEGE BOULEVARD AT QUIVIRA
11900 COLLEGE BOULEVARD
OVERLAND PARK, KANSAS 66210
(913) 469-5300

FEB 15 1989

February 10, 1989

Representative Arthur Douville
Kansas House of Representatives
Kansas State Capital Building
Topeka, KS 66612

Dear Arthur:

This will confirm my discussion with you in regard to the form of the garnishment forms and statute.

As you know, this past session of the legislature amended the garnishment law to provide that when a defendant's wages are being garnished, the employer and garnishee is to withhold the appropriate sum from his/her paychecks received during the 30 day period beginning on the day when the order of garnishment was served. Intent behind the change in law was to equalize the law as to between those persons who are paid on a monthly or semi-monthly as opposed to those who are paid weekly. Under the prior state of the law while a person who was paid once a month might be garnished for 25% of his entire earnings during the month, a person who was paid weekly was subject to garnishment of only 25% of his weekly paycheck. Since law provides that only one garnishment may be served in any 30 day period, the person who was paid weekly was in a much better position (and therefore, the creditor of the weekly paid person in a much worse position).

I have such a case where the defendant is paid weekly. The problem with the 4 form that went in affect January 1 is that it is apparently very confusing to the employers. I've enclosed herewith an answer of Sears, Roebuck and Co. on the garnishment I had issued. As you can see, included only the weekly pay period and not the pay periods for the 30 day period starting with the service of the garnishment order.

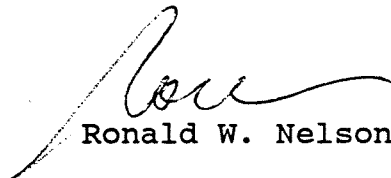
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Attachment II

I think this is probably due to the extremely confusing nature of the instructions and form. I have made some additions on the form which I believe might make the form more understandable to employers. Specifically, paragraph B should be changed to read that "this answer covers earnings for the 30 day time period, which time period includes one or more pay periods, beginning on the _____ day of _____, 19____ and ending on the _____ day of _____, 19____, which period includes the day on which the order of garnishment was served upon me." Paragraph C should be changed to read "total gross earnings due for the 30 day period covered by (b) above are \$_____ dollars." And paragraph E should read "amounts required by law to be held from each paycheck for the period or periods covered by (b) above are: "

It may be possible for someone in legislative research to make it even more plain, however I believe it essential for the best interest of employers in Kansas that the forms for answering garnishments be in plain language rather than in legislative language.

If you need any other assistance or have any other questions, please contact me at your convenience.

Sincerely yours,



Ronald W. Nelson

RWN/ke
Enclosure

H. J. 2/20/89
Att I

EUGENE L. SHORE

JUDICIARY COMMITTEE: TESTIMONY FOR FEBRUARY 20, 1989, 3:30 P.M., RM.313-S,
PROPONENT FOR HB-2353.

MR. CHAIRMAN AND MEMBERS OF THE HOUSE JUDICIARY COMMITTEE,
THANK YOU FOR ALLOWING ME TO TESTIFY AS A PROPONENT OF HB-2353.

HOUSE BILL 2353 COMES AS A RESULT OF CONCERNS STATEWIDE FOR
LEASEHOLDERS OF ROYALTIES AFTER A PRODUCER FILES FOR BANKRUPTCY.
UNDER CURRENT KANSAS LAW THE ROYALTY OWNER BECOMES AN UNSECURED
CREDITOR WHEN A PRODUCER COMPANY DECLARES BANKRUPTCY. UNDER THE
TERMS OF MOST LEASES THAT I AM FAMILIAR WITH, A FRACTION OF THE TOTAL
PRODUCTION BELONGS TO THE LEASE HOLDER IN THE FORM OF ROYALTY. IN
SOME INSTANCES, THIS MAY BE TAKEN IN KIND BUT NORMALLY IT IS TAKEN
AS A CHECK FOLLOWING THE SALE OF THE OIL OR GAS BY THE PRODUCER AND
TO A PIPELINE CUSTOMER.

UNDER CURRENT KANSAS LAW, THE ROYALTY OWNER WOULD BECOME AN
UNSECURED CREDITOR IN A BANKRUPTCY PROCEEDING. RECENT FAILURES OF
INDEPENDENT OIL AND GAS PRODUCERS AND MERGERS INVOLVING LARGE AMOUNTS
OF DOLLARS AMONG MAJOR OIL AND GAS PRODUCERS HAVE CREATED A CONCERN
AMONG THE THOUSANDS OF ROYALTY OWNERS IN KANSAS THAT PERHAPS THEIR
LIVELIHOOD MAY BE JEOPARDIZED THROUGH NO FAULT OF THEIR OWN. HOUSE
BILL 2353 ATTEMPTS TO ADDRESS THAT CONCERN. I WOULD LIKE TO INTRODUCE
GREG STUCKY OF WICHITA WHO HAS RESEARCHED THIS BILL AND WILL ATTEMPT
TO EXPLAIN IT AND ANSWER ANY QUESTIONS PERTAINING TO IT. THANK YOU,
MR. CHAIRMAN, I STAND FOR QUESTIONS.

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Attachment III

STATEMENT OF GREGORY J. STUCKY
IN SUPPORT OF HOUSE BILL 2353

My name is Gregory J. Stucky, from Wichita. I am here on behalf of Southwest Kansas Royalty Owners Association, a non-profit association comprised of about 2,000 owners of royalty interests under oil and gas leases in a 10 county region in southwest Kansas within the confines of the Hugoton Gas Field. I am a lawyer with the law firm of Fleeson, Goong, Coulson & Kitch, and the primary emphasis of my practice during my legal career has been oil and gas law. I am president-elect of the Oil and Gas Section of the Kansas Bar Association. However, neither that Section nor the Kansas Bar Association, to my knowledge, has taken any action with respect to the House Bill 2353, nor am I here as a representative of either that Section or the Kansas Bar Association.

Since the early 1980s, the oil and gas industry in Kansas has been on hard times. It seems almost daily that newspaper stories appear about another oil and gas operator who is in dire financial straits. His financial problems, however, do not stop at his doorstep. He, for instance, may fail to pay the drilling contractor or the supplier of pipes for his well. In such an unfortunate instance, however, Kansas statutes have long provided that suppliers of materials and services on a well can acquire a lien on the oil and gas leasehold estate of the nonpaying producer. That lien is provided in K.S.A. 55-207 et. seq.

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Attachment IV

If an operator fails to pay for labor and materials furnished on the leasehold, he also tends not to pay those other parties who are entitled to proceeds from the production of the oil or gas. These parties would include the royalty owners and other working interest owners. There, however, is no comparable protection for such interest owners in the leasehold or the royalty interest owner as there is for the suppliers of materials and services on the well.

This Bill is designed to correct that deficiency. It provides that working interest owners and royalty owners can secure a lien on the leasehold of the nonpaying operator and on their share of the oil and gas or the sales proceeds thereof by making the appropriate filing with the clerk of the district court of the county in which the well is located.

The royalty owner is in a particularly precarious position when his producer becomes financially strapped. In common parlance, the royalty owner is said to "own" 1/8th the gas. That description of the royalty owner's ownership rights is legally incorrect. A royalty owner owns absolutely no gas which is severed. He is merely a creditor of the producer, because that royalty owner's oil and gas lease merely provides that the royalty owner is entitled to receive a certain sum of money measured upon the value or proceeds of the sale of gas.

Although the language pertaining to oil royalty is normally more complicated than that pertaining to gas in this context, the above analysis with respect to gas royalty could also well apply to oil royalty. The ultimate ownership of the

oil depends upon an option exercised by the producer, who has the original ownership and control of the oil upon production. Until the exercise of the option in all instances and in some instances after the exercise of the option, the oil royalty owner can be considered merely a creditor of the producer.

These subtle legal differences of "ownership" and "non-ownership" can have profound consequences. For instance, in the case of a bankruptcy of the producer, its royalty owner could well be treated as a general unsecured creditor in the bankruptcy. In the event of a producer's bankruptcy, the royalty owner may not have any right to his "gas" or "oil" free of claims of the producer's creditors, because that royalty owner owns no such gas or oil. Rather, the royalty owner, the value of whose land was diminished to produce the gas or oil, has no greater right to the proceeds from the fruits of his land than the producer's merchant who sold pencils to the producer on credit.

If this Bill becomes law, the royalty owner could improve his position in bankruptcy to where a person, not fully cognizant of oil and gas law, would imagine that royalty owner to be in the first place. Under federal bankruptcy law, a lien creditor or a secured creditor is given priority over a general unsecured creditor. This Bill merely provides an avenue by which a royalty owner and, for that matter, any other interest owner as defined in the Bill, can, through a filing of a Notice of Oil and Gas Owners Security Interest and Lien, acquire that priority over general unsecured creditors in bankruptcy.

*Z.J. 2/20/89
Att IV*

Now I would like to take one minute to summarize House Bill 2353. Section 2 is the definitional section. Section 3 defines the scope of the security interest and lien created by the Bill. That section provides that an interest owner, including a royalty owner, can secure a lien upon the leasehold estate of the person who has failed to make timely payment to the interest owner and a security interest in the proceeds of the sale of the oil and gas to the extent of the interest owner's interest in that oil or gas. Subsection (c) of Section 3 places a limitation on the extent of that security interest: If a first purchaser of oil and gas does not have actual notice of the lien, that first purchaser takes the oil and gas free of the security interest and lien granted by the act. For instance, a pipeline company, who would be a first purchaser, need not worry about existence of a lien of which it had no actual notice. If that first purchaser were to receive actual notice of the filing of the lien, that first purchaser would probably go ahead and dispose of the gas or oil and suspend the proceeds until the lien is released. This is normally the procedure followed by pipeline companies in instances where they receive actual notice of a lien filing pursuant to K.S.A. 55-207, which, as explained above, relates to liens for materials and labor furnished for the well.

Section 4 of the Act provides the manner in which the interest owner can perfect his lien and security interest. The notice, as described in that section, would be filed with the clerk of the district court, the same location as the lien would be filed pursuant to K.S.A. 55-207. Under Subparagraph (b) of

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Section 4, the notice also operates as a financing statement under the Kansas Uniform Commercial Code. This provision is important because it perfects the security interest in the proceeds of the sale of the oil and gas due to the lien claimant. Subsection (c) provides for limited time - 90 days - for the notice to be filed after the due date of the payment. It also provides that the priority of that lien will be determined in accordance with K.S.A. 55-207. This means that the lien claimant filing under this Act would fall within the same priority scheme as a lien claimant under K.S.A. 55-207. Section 5 provides for the enforcement of the lien.

By creating lien and security interest rights, Kansas would not be the first state to address problems arising as a result of the poor economic environment of the oil and gas industry. Oklahoma passed legislation last year, after which this Bill is modeled. I understand that the Oklahoma Bill was in turn modeled after a Texas statute.

On behalf of the Southwest Kansas Royalty Owners Association and its 2,000 members, I urge that the legislature of the State of Kansas enact House Bill 2353.

J.D. 2/20/89
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995



KANSAS INDEPENDENT OIL & GAS ASSOCIATION

105 SOUTH BROADWAY • SUITE 500 • WICHITA, KANSAS 67202 • (316) 263-7297

February 20, 1989

TO: House Judiciary Committee

RE: **HB 2353 - Liens for Oil & Gas Interests**

KIOGA represents owners of oil and gas interests throughout Kansas. We are here to learn what the need is for this bill - as we have not heard of any, nor have we had any requests to support such legislation. Our feeling is that despite the good intentions, this bill might cause more harm than good. Kansas lien law is complex and this bill has a hard time meshing with existing Kansas statutes. This bill also involves impairment of titles.

The Kansas Supreme Court recently (1/31/89) denied an appeal of the priority of oil and gas liens in a case where the Court of Appeals reversed the Ellis County District opinion upholding KSA 55-207 in stating that a lien for drilling a well had priority over a prior savings and loan lien. KSA 55-207 does have some influence on our testimony.

We do have the following comments, beginning with Section 2:

Section 2. contains various definitions. We have some problems with the term "first purchaser". We are not sure whether there can be more than one first purchaser. The definition includes the first person who "takes, receives or purchases oil or gas from an interest owner". It seems to us that we have various people taking and receiving the oil and gas after it is produced from the well bore. The operator may take possession of it and store it on the leased premises, or the property may be put into a pipeline, or the property may be transported by truck, or the property may pass through several other persons hands until it actually passes to a purchaser who is obligated to pay for the same. Therefore, we are involved with operators, carriers, transporters, agents, brokers, etc.

Section 3. appears to give an interest owner a security interest in and lien upon the "leasehold estate" of the person who has failed to make timely payment and a security in and lien upon the oil and gas itself or the proceeds of sale if it has been sold. This security interest and lien shall continue until payment has been made to the interest owner. We make the following comments:

Many times the operator of an oil and gas lease owns no interest in the leasehold estate. Historically federal income tax implications have prompted investors to own oil and gas interests in their own individual names and to keep operating companies free and clear of any leasehold interest. It appears that once the product is sold, the security interest and lien shall attach to the proceeds of the sale. Presumably this secret security interest and lien

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follows the proceeds until such time as the lien is released pursuant to subparagraph (c). This is intended to allow a buyer in the ordinary course of business to take the product free of the security interest and lien, provided he has made payment for the same. This is an effort to allow the crude oil and the natural gas to be traded in commerce and without fear of a secret security interest and lien. However, the probable result will be that no one will want to purchase crude oil or natural gas in a secondary market until such time as the person that they are dealing with furnished them with written evidence of a payment having been made so as to give some relief from the worries of the secret security interest and secret lien. This section seems to limit the security interest in and lien upon the leasehold estate to the leasehold estate interest of the person who failed to make a payment, assuming that person has an interest in the leasehold estate. As you read Section 4. of HB 2353 you find that the limitation of a lien upon the oil and gas leasehold estate of the person who failed to make the disbursement is expanded and the notice of oil and gas owners security interest and lien is written in terms of a blanket lien upon the entire leasehold estate. This means that an innocent owner of an interest in the oil and gas leasehold estate may well have his title clouded by the filing of notice of lien when in fact he was never responsible for disbursing proceeds resulting from the sale of oil or gas. The form of notice contained in Section 4. (a) contains no language of limitation upon whose interest in the oil and gas leasehold estate is being liened. Section 3. (b) tries to give some relief when there is a bona fide dispute which has caused the withholding or suspension of proceeds. Presumably the person who has failed to make disbursement could always take advantage of this section by stating that in good faith he believes that nothing is due and owing and therefore he is suspending the funds. This would appear to release the security interest and the lien. We have doubts as to whether there is a meaningful way to implement this subsection. As noted above, subsection (c) of Section 3. is intended to allow the oil and gas to pass freely in the marketplace, but it does nothing to release the leasehold estate from the security interest and lien granted by the act.

Section 4. (a) sets out the mechanics of perfecting the security interest and lien and directs the same to be filed with the Clerk of the District Court. Although the Kansas Code of Civil Procedure provides for filing mechanic's liens with the Clerk of a District Court, the Kansas Uniform Commercial Code requires the filing of security interest either with the office of the Register of Deeds or with the office of the Kansas Secretary of State. In Kansas interested persons may check Uniform Commercial Code Financing Statement filings by obtaining searches of the records of the office of the Register of Deeds and the Secretary of State and if the same show no financing statements, the person may reasonably rely upon the same in extending credit, etc. Potential creditors dealing with oil and gas would never check with the Clerk of the District Court under present law. The form of proposed notice of oil and gas owners security interest and lien is to be "verified". This would be a change in Kansas law if there is an attempt being made to follow present Kansas mechanic's lien laws because today in Kansas a verified mechanic's lien statement is legally insufficient. The notice form is defective on its face because the claimant only needs to insert his name and address, the name of the "well" and to give a legal description of the land upon which the "well"

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is producing. This seems to ignore the concept of "leases" and "units" under which most Kansas production is sold. The form then provides that the claimant "claims a security interest and lien in the leasehold estate from which such oil or gas is severed". At this point there is no indication at all of the fact that Section 3. of the act purports to limit the security interest and lien to the oil and gas leasehold estate interest of the person who failed to make the payment. This blanket claim of a lien, without even naming any persons or person who has failed to make the payment, will put a cloud upon oil and gas leasehold estates which will make it potentially impossible to give good title to the same. The form then goes on to state that the claimant "has a security interest and lien upon such lease". There is no limitation whatsoever as the extent of said purported lien and security interest. The proposed Bill then provides that a copy of the notice shall be delivered by either certified or registered mail to a series of persons, including the person who has failed to make the timely payment, to the operator and to the first purchaser. Nothing is said about when the notice need be given nor is there any requirement that proof giving the notice needs be given. In addition, no notice need be given to the owners of the oil and gas leasehold estate. The Uniform Commercial Code requires that a financing statement bear the signature of both the debtor and the secured party; in this case there is no requirement that the debtor sign anything. Subparagraph (c) of Section 4. seems to give the claimant 90 days from the time in which payment is due under the act to file his notice of security interest and lien. We're not sure how you calculate the date upon which payment is due under the act. It also doesn't say what happens if the notice is not filed within 90 days from the so-called due date for payment. Then the act provides that "Upon the filing, the security interest and lien of the interest owners shall relate back to and be effective as of the date on which the severance occurred." It is this provision in the statute which creates the "secret security interest and lien". Apparently you would never be safe in dealing with oil and gas or with oil and gas leasehold estates unless you went to every person receiving payment from crude oil or natural gas purchaser or disburser of proceeds and obtaining from each and all of them a written statement that they have been paid to date and that they waived the right to file the secret security interest and lien. In instances when you might be dealing with as many as 100 or more royalty owners under a particular gas unit, it would seem that it would be impossible to ever know that you were safe from the threat of the secret security interest and lien. It is likely that this statute would also cause bankers great reluctance to loan money when oil and gas leasehold estates of the proceeds therefrom are to used as collateral for the loan. Nothing is said in this act about assignments of income or of oil and gas runs, which assignments are frequently made as collateral security for indebtedness for both royalty owners and working interest owners. We would assume that the Kansas Bankers' Association, the Kansas Bar Association and lenders such as The Federal Land Bank will look with disfavor upon this provision. The statute then provides that the lien shall be preferred to all other liens or encumbrances which may attach after the date on which severance occurred. This means that there is potentially always a 90-day lag time when the secret lien may come ahead of properly recorded mortgages and properly perfected security interests granted in the regular course of business to commercial lenders and creditors.

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Section 5. somewhat follows the mechanic's lien concept and provides that the security interest and lien must be foreclosed within one year after the date of filing or else they shall expire by their own terms. Interestingly enough the statute then provides that the filing fee may be recovered as part of the costs in litigation and further that "reasonable attorney fees to the prevailing party" may be awarded. We interpret this to mean that if the claimant is unsuccessful in pursuing his claim and foreclosing his security interest and lien, the claimant is subjecting himself to substantial liability for the costs of attorneys fees which will be incurred in defending such an action. This would be a change from present Kansas law.

We are not all negative on the concept of the protecting interest holders which seems to be at the heart of HB 2353. We have discussed possibly a better remedy, accomplishing the same results by having a statutory declaration that the funds in question are held as trust funds for the benefit of persons entitled to receive them. The likelihood of selling a trust fund theory in a bankruptcy proceeding would be easier than the merits of a secret lien as provided in HB 2353.

Donald P. Schnacke

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