

**A PRIMER ON PRODUCTION PAYMENTS**

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**CHAPTER 11**

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### **Biography**

Michael P. Pearson is a partner in the Houston, Texas office of Jackson Walker L.L.P. and is co-chair of the firm's Energy Practice Group. He has practiced in the area of energy law since 1978, representing numerous Texas-based, national, and international energy companies and financial institutions in a broad range of transactional matters relating to the upstream, midstream, and marketing sectors of the oil and gas industry and the wholesale and retail sectors of the electric power industry in the ERCOT market area.

### **Education**

Mr. Pearson earned his B.A., with high honors, from The University of Texas at Austin in 1975 and his J.D. from The University of Texas School of Law in 1978, where he was an Associate Editor of *The Texas Law Review*.

### **Memberships**

Mr. Pearson is a member of the State Bar of Texas, the Houston Bar Association, the International Bar Association, and the American Bar Association. Mr. Pearson is a Past Chair of the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas.

### **Awards**

Mr. Pearson is listed in *The Best Lawyers in America* under Oil & Gas Law and Natural Resources Law. He was also named a "Super Lawyer" (2007-2010) by Thomson Reuters. *Lawdragon Magazine* selected Mr. Pearson as one of the "500 Best Lawyers in America" in 2005, as one of the "500 Top Deal Makers in America" in 2007, and as a member of the "Lawdragon Top 3000" in 2010. In 2008 and 2010, Mr. Pearson was named as one of the "World's Leading Energy & Natural Resources Lawyers" in the *Expert Guide* published by Legal Media Group.

### **Publication & Speaking Engagements**

Mr. Pearson has authored numerous articles relating to energy matters, and has also been a frequent speaker at continuing legal education programs and seminars. Most recently, Mr. Pearson delivered a paper entitled "Use of Net Profits Interests in Financing Oil and Gas Transactions" at the 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute, sponsored by The University of Texas School of Law and the Oil, Gas and Energy Resources Law Section of the State Bar of Texas. Mr. Pearson also spearheaded the development and served as program chair of the first six Gas and Power Institutes sponsored by The University of Texas School of Law, the Oil, Gas, and Energy Resources Law Section of the State Bar of Texas, and the Energy Bar Association.

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MICHAEL P. PEARSON\*

## I. INTRODUCTION

In 2008, I presented a paper at the 34<sup>th</sup> Annual Ernest E. Smith Oil, Gas & Mineral Law Institute concerning the use of net profits interests as financing vehicles for oil and gas producers.<sup>1</sup> When I accepted that invitation to write, I had been contemplating, for some time, the notion of writing a companion paper about the net profits interest's more famous cousin, the production payment. I am grateful to the State Bar of Texas for giving me the opportunity to fulfill that ambition.

Production payments are not new financing vehicles and, over the years, have been the subject of a great deal of scholarly writing.<sup>2</sup> "Oil payments", as

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<sup>1</sup> Pearson, *Use of Net Profits Interests in Financing Oil and Gas Transactions*, 34<sup>TH</sup> ANN. OIL, GAS & MIN. L. INST., Paper 12 (Univ. of Texas School of Law, St. Bar of Texas OGERL Section, April 4, 2008).

<sup>2</sup> Bradford and Mosley, *Damn the Torpedoes: Continuing to Finance U.S. Oil and Gas Operations in Tumultuous Times*, 55 ROCKY MT. MIN. L. INST. 22-1 (2009) (hereinafter, "Bradford and Mosley"); Muñoz, *Financing Oil and Gas Transactions*, 4 TEXAS J. OIL, GAS & ENERGY L. 223 (2008-09) (hereinafter, "Muñoz"). McKellar, *Oil and Gas Financing – How It Works*, 32<sup>ND</sup> OIL, GAS & MIN. L. INST., Paper 11 (Univ. of Texas School of Law, St. Bar of Texas OGERL Section, March 31, 2006); (hereinafter, "McKellar"); Zlotky, *Equity Financings – Selected Issues in Structuring and Negotiating Private Equity Investments in Oil and Gas Companies*, OIL & GAS AGREEMENTS: SALES AND FINANCINGS, Paper 11 (Rocky Mt. Min. L. Fdn. 2006) (hereinafter, "Zlotky"); Alcers, *Overriding Royalty Interests: Pitfalls, Precedents and Protection*, 50 ROCKY MT. MIN. L. INST. 21-1 (2004) (hereinafter, "Alcers"); Shearer, *Oil and Gas Lending – The Borrower's Perspective*, 26<sup>TH</sup> OIL, GAS & MIN. L. INST., Paper 7 (Univ. of Texas School of Law, St. Bar of Texas OGERL Section, March 31, 2000) (hereinafter, "Shearer"); Murray, *Structured Finance for the Oil and Gas Industry*, HOUSTON COMMERCIAL

they were then known, began to appear in Texas jurisprudence in the 1920s and 1930s as methods of providing to lessors consideration in addition to lease bonus and conventional lessor's royalty in connection with the granting of oil and gas leases and vendor financing to lessees. In the late 1950s and 1960s, the production payment was the centerpiece to a transaction structure known as the "ABC transaction" that allowed oil and gas companies to achieve

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FINANCE LAWYERS FORUM (Feb. 16, 1999) (hereinafter, "Murray I"); Harrell, Rice and Shearer, *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 THE BUSINESS LAWYER 885 (1997) (hereinafter, "Harrell, Rice and Shearer"); Gibson, *Pitfalls of Production Payments*, REVIEW OF OIL AND GAS LAW XI (Dallas Bar Ass'n Energy L. Section, August 22, 1996) (hereinafter, "Gibson"); Dunlap, *Issues in Trade and Vendor Financing: You Scratch My Back and I'll Scratch Yours*, "14<sup>TH</sup> ADV. OIL, GAS & MIN. L. COURSE, Paper B (St. Bar of Texas, September 19-20, 1996) (hereinafter, "Dunlap I"); Murray, *The Oil and Gas Lawyer's Role in the New Financing Techniques*, 42 MIN. L. INST. \_\_\_ (1995) (hereinafter, "Murray II"); Loftspring, *Gas Marketing in the 90's: Structure and Strategy*, 21<sup>ST</sup> OIL, GAS & MIN. L. INST., Paper 7 (Univ. of Texas School of Law, St. Bar of Texas OGML Section, March 24, 1995) (hereinafter, "Loftspring"); Heintz, *Emerging Alternative Financing Structures in the Energy Industry*, 45<sup>TH</sup> OIL & GAS INST. 5-1 (Matthew Bender 1994) (hereinafter "Heintz"); Glass, *Production Payments – New Twists on Old Techniques*, 20<sup>TH</sup> OIL, GAS & MIN. L. INST., Paper 6 (Univ. of Texas School of Law, St. Bar of Texas OGML Section, March 25, 1994) (hereinafter, "Glass"); Dunlap, *Current Developments in Energy Financing: Alternatives to Traditional Production – Secured Borrowing*, OIL & GAS LAW 1994 (Okla. City, Univ. School of Law, April 28, 1994) (hereinafter, "Dunlap II"); Strohl, *Gas Into Gold: The New Alchemy of Financing Oil and Gas Acquisitions in the 1990s*, 39 ROCKY MT. MIN. L. INST. 16-1 (1993) (hereinafter, "Strohl"); Cross, *Current Developments in Oil and Gas Financing*, COMMERCIAL FINANCE GUIDE (Matthew Bender 1993) (hereinafter, "Cross"); Terrell, *Overriding Royalties and Like Interests – A Review of Nonoperating Lease Interests*, ROCKY MT. MIN. L. SPECIAL INST., Ch. 4 (1993) (hereinafter, "Terrell"); Hubert and Taylor, *Creation and Conveyance of Oil and Gas Leasehold Burdens*, 31 ROCKY MT. MIN. L. INST. 14-1 (1985) (hereinafter, "Hubert and Taylor"); and Barnett and Coffin, *New Financing Techniques in the Oil and Gas Industry*, 34<sup>TH</sup> OIL & GAS INST. 431 (Matthew Bender 1983) (hereinafter, "Barnett and Coffin").

favorable federal income tax treatment for sales and purchases of producing oil and gas properties. During the 1990s, so-called “volumetric” production payments received renewed attention as asset securitization devices that provided producers with the opportunity to access financing through the capital markets and the gas aggregators who generally facilitated these transactions, such as Enron, with the opportunity to acquire “in bulk” gas reserves on a forward basis. Even today, because of the well-defined legal characteristics of the production payment, its favorable status under bankruptcy law, and its federal income tax treatment, particularly from the perspective of tax exempt investors (“TEOs”) seeking to avoid “unrelated taxable business income” (“UBTI”)<sup>3</sup>, the production payment remains an important source of financing for oil and gas producers.

This paper will discuss: (a) the legal characteristics of production payments; (b) their treatment for federal income tax, bankruptcy, and accounting purposes; and (c) some of the issues that should be taken into account when documenting production payment transactions.

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<sup>3</sup> Section 511 of the Internal Revenue Code of 1986, as amended (the “Tax Code”) imposes a tax on the UBTI of most TEOs. I.R.C. § 511. Pursuant to Section 512(a)(l) of the Tax Code, UBTI includes the gross income derived by a TEO from any unrelated trade or business regularly carried on by it. I.R.C. § 512(a)(1). The phrase “unrelated trade or business” is generally defined to mean any trade or business the conduct of which is not substantially related to the performance of the TEO’s exempt function. IRC § 513(a). Ownership of an operating interest in oil, gas, or other minerals in place, even if held indirectly by a TEO as a limited partner, is an unrelated trade or business for the TEO. See *Rev. Rul.* 69-179, 1969-1 C.B. 158; IRC § 512(c). All income from “royalties (including overriding royalties) whether measured by production or by gross or taxable income” from a property, however, is specifically excluded from UBTI. IRC § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). Production payments not taxed as a loan under Section 636 of the Code are treated in the same manner as royalties for purposes of calculating UBTI. In the case of production payments taxed as a loan under Section 636, only the portion of any payments made in discharge thereof that is the equivalent of interest is treated as interest in computing UBTI. Treas. Reg. § 1.512(b)-1(b). Accordingly, the “interest-equivalent” payments are generally not included in computing UBTI under the terms of Section 512(b) of the Tax Code and Treas. Reg. 1.512(b)-1(a).

## II. CHARACTERISTICS OF PRODUCTION PAYMENTS

### A. Comparison with Other Non-Operating Interests

The production payment is one of several interests that may be created, by grant or reservation, out of the mineral and the oil and gas leasehold estates and that do not entitle their owners to participate in, or obligate them with respect to, oil and gas operations.<sup>4</sup>

The most common of these interests is the overriding royalty interest, defined as an interest in oil and gas produced at the surface that is carved out, by grant or reservation, of the oil and gas leasehold estate or the lessee’s share of production, free of expenses of development, operations, and production, and that continues for the life of the oil and gas lease burdened thereby.<sup>5</sup> Although occasionally used to refer to any royalty payable to the lessor in excess of the customary lessor’s royalty, the term overriding royalty now refers almost exclusively to a non-operating interest carved out of the oil and gas leasehold estate.<sup>6</sup> Like overriding royalty interests, net profits interests may be created (a) by an oil and gas lessee as an additional benefit for the lessor, often reflected as a reserved interest under the terms of the oil and gas lease<sup>7</sup> or (b) by the lessee by grant or reservation in favor of a third party as a non-operating interest carved out of the oil and gas leasehold estate.<sup>8</sup> Unlike an overriding royalty interest, a net profits interest is not measured by a fractional share of production free of costs of development, operations, and production, but rather by a percentage of the “net profits” from the operation of the burdened lease. As such, a net profits interest entitles its owner to receive revenues only to

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<sup>4</sup> See 2 P. MARTIN & B. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 417 (LexisNexis 2009) (hereinafter, “WILLIAMS & MEYERS”).

<sup>5</sup> 2 WILLIAMS & MEYERS, *supra* note 4, § 418 at 351 n.2.1. This definition was substantially quoted in *Sawyer v. Guthrie*, 215 F.Supp. 1254, 1257 n.1 (D.Wyo. 2002), and *Pinnacle Operating Co. v. ETTCO Enterprises, Inc.*, 914 So.2d 1144 (La.App. 2005). See *Alamo Nat’l Bank of San Antonio v. Hurd*, 485 S.W.2d 335, 339 (Tex. Civ. App. – San Antonio 1972, writ ref’d n.r.e.).

<sup>6</sup> *In re GHR Energy Corp.*, 972 F.2d 96, 99 (5<sup>th</sup> Cir. 1992). See 2 WILLIAMS & MEYERS, *supra* note 4, § 418 at 351; Terrell, *supra* note 2, at 6.

<sup>7</sup> E.g., *Louisiana Land & Exploration Co. v. Donnelly*, 394 F.2d 273 (5<sup>th</sup> Cir. 1968). See Terrell, *supra* note 2, at 9.

<sup>8</sup> See 2 WILLIAMS & MEYERS, *supra* note 4, § 424.1 at 438-39; Terrell, *supra* note 2, at 9; Hubert and Taylor, *supra* note 2, at 14-4, 14-5.

the extent that operations on the burdened lease yield “net profits”.<sup>9</sup>

Production payments are commonly defined as a share of oil or gas as produced, free of costs of development, operations, and production, that terminates when a given volume of production has been paid to, or a specified sum from the sale of such production has been realized by, the owner of the production payment.<sup>10</sup> While many of the older cases refer to “oil payments”, this paper will use the more general term “production payment” unless a specific reference to oil or gas is appropriate, recognizing that the term “oil payment” is generally synonymous with the term “production payment”.<sup>11</sup>

Like overriding royalties and net profits interests, production payments may be created (a) by an oil and gas lessee as an additional benefit for the lessor, often as a reserved interest under the terms of the oil and gas lease, or (b) most commonly, by the lessee by grant or reservation.<sup>12</sup> Neither the overriding royalty interest, the production payment, nor the net profits interest entitles the owner thereof to any ownership interest in depreciable leasehold equipment or to explore, drill, develop, or operate the burdened lease for the production of oil or gas, nor do they subject the owner to personal liability for the costs of such activities. The owner of the overriding royalty interest, the production payment, and the net profits interest has no personal liability with respect to the satisfaction or payment of such interests, and all of such non-operating interests must be satisfied entirely out of production from the burdened lease.<sup>13</sup>

The key point of distinction between overriding royalty interests and net profits interests, on the one hand, and production payments, on the other hand, is the production payment’s limited duration. Unlike overriding royalty interests and net profits interests

<sup>9</sup> See 1 E. SMITH & J. WEAVER, TEXAS LAW OF OIL & GAS § 2.4.D at 2-68 (LexisNexis 2009) (hereinafter, “SMITH & WEAVER”); 2 WILLIAMS & MEYERS, *supra* note 4, § 424 at 437-38.

<sup>10</sup> E.g., *NL Industries, Inc. v. GHR Energy Corp.*, 940 F.2d 957, 967-68 (5th Cir. 1991); *Alamo Nat’l Bank of San Antonio v. Hurd*, 485 S.W.2d 335, 340 (Tex. Civ. App. – San Antonio 1972, writ ref’d n.r.e.). Both cases quote 2 WILLIAMS & MEYERS, *supra* note 4, § 422 at 366.10.

<sup>11</sup> See 2 WILLIAMS & MEYERS, *supra* note 4, § 422 at 366. *But see Pan Oil and Gas Exploration, Inc. v. Kelt Kansas, Inc.*, 17 Kan. App. 2d 121, 833 P.2d 136, 139 (1992) (the term “oil payment” held to ambiguous on the facts of the case.).

<sup>12</sup> See, generally, *id.* at § 422 at 367-68.

<sup>13</sup> See *id.* at § 422.3 at 381-82.

(which continue for the life of the burdened lease), however, production payments terminate when a specified volume of hydrocarbons or a specified sum of money from the sale of production has been received by the owner of the production payment.<sup>14</sup>

## B. Legal Characterization of Production Payments in Texas

Production payments generally follow one of three models: (a) a grant or reservation of the right to receive a fraction of the proceeds from the sale of oil or gas produced from the burdened lease until a certain sum of money has been recovered; (b) a grant or reservation of a fraction of the oil and gas as produced from the burdened lease until the value thereof or the proceeds therefrom equals a certain sum of money; or (c) a grant or reservation of a fraction of the oil and gas as produced from the burdened lease until a specified quantity of hydrocarbons has been delivered.<sup>15</sup> Production payments created based on either of the first two models, which are satisfied by the grantee’s receipt of a sum of money from the sale of production, will be referred to in this paper as “dollar-denominated production payments” or “DDPPs”.<sup>16</sup> Production payments created based on the third model, which are satisfied by the grantee’s receipt of a specified volume of production, will be referred to in this paper as “volumetric production payments” or “VPPs”.<sup>17</sup>

As will be seen from the following discussion, there is no distinction under Texas law in the legal characteristics ascribed to dollar-denominated production payments and volumetric production payments.

<sup>14</sup> See, generally, Hubert and Taylor, *supra* note 2, at 14-4, 14-5; Terrell, *supra* note 2, at 9, 10. See *First City Nat’l Bank of Midland v. Concord Oil Company*, 808 S.W.2d 133, 135 (Tex. App. – El Paso 1991, no pet.) (production payment in controversy remained in effect until the earlier of (i) 15 years from the effective date or (ii) there remained “in the ground and unproduced” not less than 10% of the estimated commercially recoverable reserves).

<sup>15</sup> See Walker, *Oil Payments*, 20 TEXAS L. REV. 259, 260 (1942) (hereinafter, “Walker”). Professor Walker also noted a fourth, more archaic model which is rarely used today: a grant or reservation of a fraction of the oil and gas in place until the production from the oil and gas leasehold estate causes the fractional interest to realize a certain sum of money. *Id.* See also Gibson, *supra* note 2, at 1.

<sup>16</sup> See, e.g., Bradford and Mosley, *supra* note 2, at 22-9.

<sup>17</sup> See, e.g., Bradford and Mosley, *supra* note 2, at 22-15; Muñoz, *supra* note 2, at 228-29; Heintz, *supra* note 2, at 5-5.

1. Basic Principles of Texas Oil and Gas Law. The conceptual basis for the treatment by the Texas courts of production payments rests upon certain fundamental principles of Texas oil and gas law and, in particular, the treatment accorded by the Texas courts to the various classes of royalty interests, to which production payments have been held to be analogous. The first of these principles is that, under Texas law, oil and gas can be owned in place - that is, while they still rest within the geological strata underlying the land in question and prior to their production and consequent reduction to physical possession.<sup>18</sup> Some other jurisdictions hold that fugacious minerals such as oil and gas cannot be owned until they have been reduced to possession.<sup>19</sup>

a. Oil and Gas Leases. Consistent with Texas' adoption of the "ownership in-place" theory, an oil and gas lease in Texas is not a "lease" of real property in the common understanding of real estate law. Rather, the oil and gas lease is a conveyance that effects a severance of the surface estate from the mineral estate in the leased premises and creates in the lessee an estate in real property in the nature of a fee simple determinable, with the lessor retaining a reversionary interest known as a possibility of reverter.<sup>20</sup> The possibility of reverter is an estate in land that vests in interest in the lessor upon the execution of the oil and gas lease and may be assigned or devised.<sup>21</sup> The possibility of reverter gives the lessor no possessory rights in the mineral estate during the term of the lease; all of such rights pass to and vest in the lessee.<sup>22</sup>

b. Royalty Interests. Based on these principles, it is not unexpected that the Texas courts have consistently treated all of the various types of royalty and non-operating interests -- including the lessor's royalty in an oil and gas lease, non-participating royalties (royalty carved out of the mineral owner's estate), overriding royalties, and production payments

-- as the same kind of legal interest, and as constituting interests in real property. The seminal Texas case in this regard is *Sheffield v. Hogg*.<sup>23</sup> In *Sheffield*, the issue concerned whether the lessor's royalty under several oil and gas leases was taxable as an interest in real estate, or whether the lease royalty clauses merely created personal covenants by the lessees in favor of the lessors. The royalty clauses in these leases, as is typical, provided that the lessor would have the right to take in kind his royalty share of oil, and that as gas royalty, the lessor would receive his royalty share of the money realized from the sale of the gas. The Texas Supreme Court held that the lessor's royalty, whether payable in money or in kind, is an interest in land. According to the court:

[T]he lessor owning ... the right to a portion of the proceeds or profits derived from the lessee's ... sale of the minerals ... have and own ... [an] interest in land.<sup>24</sup>

The court rejected the view that a right to receive a share of the proceeds of production is merely a personal covenant:

[T]he fact that rent is to be paid in money does not make it any the less a profit issuing out of the land. ... A right to land essentially implies a right to the profits accruing from it ... 'For what' says Lord Coke ... 'is the land, but the profits thereof.'<sup>25</sup>

In so holding, the court expressly disapproved all statements in prior Texas cases that disagreed or were inconsistent with the foregoing conclusions.<sup>26</sup>

c. Overriding Royalty Interests. Because production payments are often treated as being analogous to overriding royalty interests, a brief review of key cases regarding the characterization of overriding royalty interests under Texas law is relevant, particularly as a predicate for the discussion of the treatment of production payments under bankruptcy law.<sup>27</sup> An early Texas case, *Dashko v. Friedman*,<sup>28</sup> held that overriding royalty interests do not constitute interests in land, but rather are

<sup>18</sup> *Texas Co. v. Daugherty*, 107 Tex. 226, 176 S.W. 717, 719 (1915).

<sup>19</sup> See notes 71-93, *infra*, and accompanying text.

<sup>20</sup> E.g., *Stephens County v. Mid-Kansas Oil and Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923).

<sup>21</sup> *Caruthers v. Leonard*, 254 S.W., 779 (Tex. Comm'n App. 1923, judgment adopted); *Bagby v. Bredthauer*, 627 S.W.2d 190, 197 (Tex. App. - Austin 1981, no writ).

<sup>22</sup> *Texas Oil & Gas Corp. v. Ostrum*, 638 S.W.2d 231, 234 (Tex. App. - Tyler 1982, writ ref'd n.r.e.).

<sup>23</sup> 124 Tex. 290, 77 S.W.2d 1021 (1934).

<sup>24</sup> *Id.* at 1024.

<sup>25</sup> *Id.* at 1027-28.

<sup>26</sup> *Id.* at 1025. See note 32, *infra*, and accompanying text.

<sup>27</sup> See notes 135-142, *infra*, and accompanying text.

<sup>28</sup> 59 S.W.2d 203 (Tex. Civ. App. - Texarkana 1933, no writ).

contractual rights of the overriding royalty owner to receive its share of production revenues from the owner of the lease. In *Dashko*, the plaintiff sued to compel specific performance of an oral agreement to assign to him an overriding royalty interest equal to a specified fraction of the oil and gas produced and saved, to be delivered to the purchaser in the pipelines “as, if and when produced”. The court of civil appeals held that the trial court had erred in sustaining a special exception to the plaintiff’s petition because the contract in question did not deal with the sale of an interest in the minerals in fee, but only with an interest in minerals after their severance from the land in question and their corresponding conversion from real to personal property.<sup>29</sup> In so holding, the court emphasized that the phrase “as, if and when produced” indicated the intent of the parties that the plaintiff was to acquire an interest in the minerals only after their production.<sup>30</sup>

Professor A. W. Walker, the distinguished Texas oil and gas law authority, is highly critical of the *Dashko* decision, and in particular its construction of the phrase “as, if and when produced” as used in the contract in question, stating:

Actually this language is used for the purpose of fixing the time of payment and in order to make it clear that payment is only to be made out of production, and its use does not indicate an intention by the parties that no present interest in the oil in place shall be vested in the payee.<sup>31</sup>

Subsequent Texas decisions clearly have repudiated the analytical approach represented by *Dashko*. In *Sheffield*, the Texas Supreme Court expressly disapproved cases such as *Dashko*, stating without specifically identifying the cases in question:

Our attention has been called by counsel to frequent other declarations by Texas appellate judges which cannot be reconciled with our present holdings . . . It is enough to say that declarations contrary to what is necessarily decided in this opinion are disapproved.<sup>32</sup>

<sup>29</sup> *Id.* at 204-5.

<sup>30</sup> *Id.* at 204.

<sup>31</sup> Walker, *supra* note 15, at 263.

<sup>32</sup> *Sheffield v. Hogg*, 124 Tex. 290, 77 S.W.2d 1021, 1025 (1934). Subsequently, in *Minchen v. Fields*, 162 Tex. 73, 345 S.W.2d 282, 287-88 (1961), the Texas Supreme Court, in discussing the characterization of the production payment in controversy, quoted the language from

After *Sheffield*, the Texas courts have consistently held that overriding royalty interests are interests in land. For example, in *Frost v. Standard Oil Co. of Kansas*,<sup>33</sup> plaintiffs, the owners of an overriding royalty interest, sued for damages to that interest caused by the defendant’s negligence in allowing a well to blow out. Defendants filed a plea of privilege, arguing that venue was not proper in the county where the land was located because plaintiffs’ action was not an action for damages to land. The court of civil appeals rejected the defendant’s contention and held that an overriding royalty, like the lessor’s royalty in *Sheffield*, is an interest in land, stating:

[T]hough an overriding royalty is carved out of the working interest of a lease, the owner of the overriding royalty stands in the same relation to the operator of the lease, as regards the right to receive some fractional portion of the oil and gas produced and saved, as does the owner of a royalty interest.<sup>34</sup>

2. Production Payments in Texas. As was the case with overriding royalty interests, an early federal court case applying Texas law held that a dollar-denominated production payment constituted a lien on the hydrocarbons produced from the burdened lease and not an interest in land.<sup>35</sup> Since *Sheffield*, however,

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Professor Walker’s article criticizing *Dashko*’s construction of the phrase “as, if and when produced”, concluding as did Professor Walker, that the use of such phrase “does not indicate an intention by the parties that no present interest in the oil in place shall be vested in the payee.” Similar repudiations of *Dashko* appear in *Guffey v. Utex Exploration Company*, 375 S.W.2d 1, 4 (Tex. Civ. App. - San Antonio 1964, writ ref’d n.r.e.), and *U.S. Pipeline Corp. v. Kinder*, 609 S.W.2d 837, 839 (Tex. Civ. App. - Fort Worth 1980, writ ref’d n.r.e.).

<sup>33</sup> 107 S.W.2d 1037 (Tex. Civ. App.- Galveston 1937, no writ).

<sup>34</sup> *Id.* at 1039. The same result was reached in, e.g., *Kelly Oil Co., Inc. v. Svetlik*, 975 S.W.2d 762, 764 (Tex. App. - Corpus Christi 1998, writ denied); *T-Vestco Litt v. Lu-Cal One Oil Co.*, 651 S.W.2d 284, 291 (Tex. App. - Austin 1983, writ ref’d n. r. e.); *Belgam Oil Co. v. Wirt Franklin Petroleum Corporation*, 209 S.W.2d 376, 378-9 (Tex. Civ. App. - Galveston 1948, no writ); *McDonald v. Follett*, 175 S.W.2d 671, 674 (Tex. Civ. App. - Galveston 1943), *aff’d*, 142 Tex. 616, 180 S.W.2d 334 (1944).

<sup>35</sup> *Standley v. Graham*, 83 F.2d 489 (5<sup>th</sup> Cir. 1936), *cert. denied*, 299 U.S. 593, 57 S. Ct. 115 (1936), citing the

the Texas courts have consistently held that production payments, whether volumetric or dollar denominated and even when clearly employed as financing devices, constitute interests in land rather than security for a debt as long as the right of the production payment owner to receive payment, either in kind or in money, is conditioned upon the sufficiency of the hydrocarbon production from the burdened lease, and is not an absolute obligation of the grantor. Three Texas cases are principally responsible for establishing the modern characterization of production payments under Texas law.

(a) *Tennant v. Dunn*. The first of these cases was *Tennant v. Dunn*.<sup>36</sup> In *Tennant*, the lessee under an oil and gas lease conveyed to Mrs. Dunn, by a recorded instrument of conveyance as a dollar denominated oil payment, “all the right, title and interest” of the lessee in the subject lease “insofar as it covers and only covers Twenty Five thousand dollars (\$25,000) worth of oil at the market price thereof . . . out of and from five forty-eighths (5/48) of seven-eighths (7/8) of the oil produced from” the well located on the subject lease.<sup>37</sup> The language of the grant did not use, at any point, the phrase “as, if and when produced”. A receiver was appointed for the estate of the lessee, and Mrs. Dunn intervened in the receivership proceedings to establish her ownership of the production payment. The trial court held that Mrs. Dunn acquired no interest either in the oil in place or in the oil once produced, and that her claim was an unsecured claim against the estate of the lessee subordinate to the costs of the receivership and the claims of all secured creditors. The court of civil appeals reversed the trial court decision and held that the assignment conveyed to Mrs. Dunn the indicated fraction of the oil in place until the amount of the production payment had been recovered.<sup>38</sup>

The Texas Supreme Court reformed and affirmed the holding of the court of civil appeals. The court disagreed with the conclusion of the court of civil appeals that the assignment conveyed to Mrs. Dunn an interest in the oil in place, stating that such instrument “does not purport to convey oil in place, and it gives the assignee or the grantee no dominion over the oil

before production and no right to enter upon the land to produce it”.<sup>39</sup> The court continued, “It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. . . .”<sup>40</sup> After discussing the Texas Supreme Court’s decision in the *Sheffield* case, the court concluded:

“The gist of the opinion in *Sheffield v. Hogg* is that oil and gas royalties, whether payable in kind or in money, and . . . arising from the ordinary lease of land in which the lessor owns the minerals, . . . should be adjudged to be present interests in land rather than mere rights in personalty at some uncertain date, because they are profits arising out of land, and, further, such classification, which accords with the practice in the oil and gas industry, furnishes a stability highly important, if not essential, to the structure of that business. For the same reasons, the right created by the assignment to Mrs. Dunn should be classified an interest in land.

It is our opinion that the instrument under consideration conveys an interest in the land, that its filing and recording in the deed records gives constructive notice, and that the interest so created (giving the right to the quantity of oil specified as the same is produced from the well) is superior to interests thereafter assigned or conveyed and to liens subsequently attaching or fixed, and also superior to claims of unsecured creditors and to expenses and costs of the receivership.<sup>41</sup>

(b) *Sheppard v. Stanolind*. The second of the three principal production payment cases is a court of civil appeals decision, *Sheppard v. Stanolind Oil & Gas Co.*<sup>42</sup> In *Sheppard*, the State of Texas executed two oil and gas leases that provided for the reservation to the State of a conventional royalty interest as well as a dollar-denominated production payment, called

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Texas Court of Appeals decision in *Dashko v. Friedman*, 59 S.W.2d 203 (Tex. Civ. App. - Texarkana 1933, no writ). See notes 135-142, *infra*, and accompanying text.

<sup>36</sup> 130 Tex. 285, 110 S.W.2d 53 (1937).

<sup>37</sup> 110 S.W.2d at 55.

<sup>38</sup> *Id.* at 56.

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<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 57.

<sup>42</sup> 125 S.W.2d 643 (Tex. Civ. App. - Austin 1939, writ ref’d)

an “oil bonus” by the court, equal to a specified sum of money “to be paid out of 1/6 of 5/6 of the first oil and gas, if, as and when produced from” the leases in question.<sup>43</sup> The leases also reserved a lien upon the lessee’s share of production to secure his payment of the royalties and production payments reserved by the State. The lessee filed suit against the State of Texas to recover certain production taxes previously paid by the lessee with respect to production attributable to the State’s reserved production payments. The lessee asserted that such production payments were in the nature of royalty interests and, as such, the production taxes payable with respect to such production payments were payable by the State, and not by the lessee out of its working interest share of production from the relevant leases. The State of Texas argued, on the other hand, that the production payments constituted nothing more than vendor’s liens securing the payment to the State of a portion of the lease bonus for the relevant leases, and that the State therefore acquired no taxable interest in the production used to satisfy such payments.<sup>44</sup>

The trial court rendered judgment in favor of the lessee, and the court of civil appeals affirmed, holding that the production payments reserved by the State were present interests in land analogous to overriding royalty interests, and that the State was therefore liable for the production taxes due for such interests.<sup>45</sup> In so holding, the court, citing the *Sheffield* case as controlling precedent, stated:

[T]he interest here involved, by whatever name it may be properly called, is an interest in real estate, an interest in production under the leases, and such an interest as imposes upon its owner the burden of the production tax under the statute we are considering.<sup>46</sup>

<sup>43</sup> *Id.* at 645.

<sup>44</sup> *Id.* at 645.

<sup>45</sup> *Id.* at 648.

<sup>46</sup> *Id.* at 649. In so holding, the court in *Sheppard* apparently attached no significance to the inclusion in the lease of the phrase “if, as, and when produced.” A similar result was reached two years earlier in *Danciger Oil & Ref’g Co. v. Christian*, 109 S.W.2d 980, 989 (Tex. Civ. App. – Galveston 1937, writ dismissed), a case in which an oil and gas producer conveyed to a drilling contractor, in partial payment of the monthly rig rental charges, a fractional share of the “first oil or gas produced, saved, and sold” from the affected lease each month, “if and when produced.” The court of civil appeals affirmed the trial court’s judgment that the production payment was an interest in real property that would support an action for

(c) *State v. Quintana*. The final case in this trilogy is the Texas Supreme Court’s decision in *State v. Quintana Petroleum Co.*,<sup>47</sup> decided three years after *Tennant* and one year after *Sheppard*. In *Quintana*, the lessor under an oil and gas lease reserved, in addition to the customary lessor’s royalty, a production payment described as “one-fourth (1/4) of the remainder of any oil, gas or minerals produced from said land after the reservations above set forth are made, until the proceeds of the sale . . . by grantor of said one-fourth of the remainder shall aggregate Two Million Dollars (\$2,000,000.00) whereupon this reservation of title to said 1/4 interest shall terminate and this interest shall vest in grantee and its assigns.”<sup>48</sup> The issue in the case was whether the referenced production payment constituted a taxable interest in land for which the lessor was liable. The trial court found that the lessor owned no taxable interest in the production payment, but the court of civil appeals, on rehearing, reversed that judgment, rendered judgment in favor of the defendant lessees, and held that the lessor did, in fact, own a taxable interest in land.<sup>49</sup>

The Texas Supreme Court affirmed the judgment of the court of civil appeals and held that the referenced production payment constituted an interest in land that was taxable under ad valorem tax laws against the lessor as the owner thereof. In so holding, the court stated:

The . . . interest reserved in the lease executed by [the lessor] is not different in nature from the ordinary 1/8 royalty interest. The only difference is that it may not endure for as long a period as does the royalty reserved without limitation.<sup>50</sup>

The court cited as controlling precedents the *Tennant* and *Sheffield* cases, as well as the court of civil appeals decision in *Sheppard*.

(d) Non-Recourse Obligation. The key element in determining the legal characterization of a production payment under Texas law is whether the

specific performance by the drilling contractor, *id.*, again attaching no significance to the phrase “if and when produced.” See also *Texas Conservative Oil Co. v. Jolly*, 149 S.W.2d 265 (Tex. Civ. App. – El Paso 1941, no writ).

<sup>47</sup> 134 Tex. 179, 133 S.W.2d 112 (1939), *reh. denied*, 134 Tex. 191, 134 S.W.2d 1016 (1940).

<sup>48</sup> 133 S.W.2d at 112-13.

<sup>49</sup> *Id.* at 113.

<sup>50</sup> *Id.* at 114-15.

grantor/payor of the production payment is absolutely obligated to satisfy in full the amount of the production payment. If not, the production payment should be characterized as a presently vested interest in real property. If so, however, the production payment is likely to be treated as security for a debt.

The Texas Supreme Court first addressed this issue in *State v. Quintana Petroleum Co.*<sup>51</sup> In *Quintana*, the lessor argued that the \$2,000,000 production payment reserved by the lessor under the relevant oil and gas lease constituted nothing more than security for the payment of the dollar amount thereof as additional consideration for the granting of the lease, and that the lease should be construed as a conveyance of the entire 7/8 of the mineral estate to the lessee, subject to the reservation by the lessor of a lien covering 1/4 of such 7/8 to secure the payment of such amount out of the proceeds of production.<sup>52</sup> In rejecting the lessor's claim and holding that the referenced production payment constituted an interest in land that was subject to ad valorem taxation in the hands of the lessor, the court stated:

The reservation is unlike the vendor's lien for two reasons, first, because no lien is retained on any part of what is conveyed to the lessee - the 7/32 [1/4 of 7/8] is not conveyed, and second, because no obligation is imposed upon the lessee to pay the \$2,000,000 - the lessor obtains payment only out of a part of the oil if and when produced. . . [U]nder the reservation of the 7/32 of the minerals produced from the land the lessor has a "direct or immediate interest" in the minerals actually produced as distinguished from the interest of a lien or which is "collateral as security for a personal obligation of absolute liability".<sup>53</sup>

In support of its holding, the Texas Supreme Court cited the judgment and principles of law stated in *Sheppard v. Stanolind Oil & Gas Co.*<sup>54</sup> Recall that, in *Sheppard*, the State of Texas argued that its reservation of production payments in two oil and gas leases, the payment of which was secured by reserved liens on the lessee's share of production, constituted

vendor's liens securing the payment to the State of a deferred portion of the lease bonus.<sup>55</sup> The Austin Court of Civil Appeals rejected the State's argument, stating:

It may be conceded, at the outset, that if the sums in question constituted an absolute personal liability of the lessee secured by a retained vendor's lien upon the property conveyed by the lease, the legal and beneficial title to such property would pass in fee to the lessee for taxing and all other purposes except only as security for the purchase money debt and the incidental right of the lessor to cancel for breach of the promise to pay the debt...Where the bonus, though deferred, is absolutely payable the lessor's interest in the property on that account does not exceed that of a lienor. But when the bonus is conditional absolutely upon production, the interest of the lessor on that account is actual and real, wholly independent of whether he is secured in his right to payment from production or otherwise.<sup>56</sup>

Based on the analysis in the *Sheppard* and *Quintana* cases, the Texas courts have uniformly held that production payments, even when clearly employed as financing devices, constitute interests in real property rather than security for a debt as long as the right of the payee to receive such payment is conditioned upon production and not an absolute obligation of the payor. The case most often cited in this regard is *Prince Bros. Drilling Co. v. Fuhrman Petroleum Corp.*<sup>57</sup> In *Prince Bros.*, an ad valorem tax case, a drilling contractor contracted with a producer to drill various oil wells for the company on one of its oil and gas leases. As consideration, the drilling contractor received a production payment payable out of the oil and gas produced from the wells drilled. The document creating the production payment expressly negated the producer's personal obligation to pay the drilling contractor's charges, although it appears to have given the producer the option to

<sup>51</sup> 134 Tex. 179, 133 S.W.2d 112 (1939), *reh. denied*, 134 Tex. 191, 134 S.W.2d 1016 (1940).

<sup>52</sup> 133 S.W.2d at 113.

<sup>53</sup> *Id.* at 116.

<sup>54</sup> 125 S.W.2d 643 (Tex. Civ. App. – Austin 1939, writ ref'd).

<sup>55</sup> *Id.* at 645. This result is consistent with the result reached three years earlier in *Pansy Oil Co. v. Federal Oil Co.*, 91 S.W.2d 453 (Tex. Civ. App. – Texarkana 1936, writ ref'd n.r.e.).

<sup>56</sup> *Id.* at 646.

<sup>57</sup> 150 S.W.2d 314 (Tex. Civ. App. - El Paso 1941, writ ref'd).

terminate the production payment by paying in cash the amount then outstanding thereunder.<sup>58</sup> The drilling contractor contended that the production payment was merely in the nature of a mortgage securing the producer's payment of the amount due, so that the drilling contractor was not liable for the ad valorem taxes assessed with respect to such interest.<sup>59</sup> The court rejected the drilling contractor's argument, noting that the contract imposed no personal liability for the payment of such charges on the producer, and held that the drilling contractor's production payment constituted a taxable interest in land in the hands of the drilling contractor, and not a mortgage.<sup>60</sup>

(e) Subsequent Cases. Based on the principles stated in *Tennant, Sheppard*, and *Quintana*, it is clear that, under Texas law, production payments, whether volumetric or dollar-denominated, are treated as being analogous to overriding royalty interests and, therefore, as presently vested interests in real property, regardless of whether the produced payment is created by a grant or reservation of (a) an interest in oil and gas in place, (b) an interest in the oil and gas leasehold estate, (c) an interest in hydrocarbons if, as, and when produced from the oil and gas leasehold estate, or (d) an interest in the proceeds from the sale of hydrocarbons if, as, and when produced from such oil and gas leasehold estate.<sup>61</sup> Subsequent decisions of the Texas courts have uniformly adhered to this characterization in many different types of cases, including ad valorem tax cases,<sup>62</sup> production or

severance tax cases,<sup>63</sup> trespass to try title actions,<sup>64</sup> venue disputes,<sup>65</sup> statute of frauds cases,<sup>66</sup> and interpretations of mineral and royalty grants, reservations, and devises.<sup>67</sup>

(f) Type of Real Property Interest. Although numerous Texas cases have dealt with the issue whether a production payment constitutes an interest in real property, the disposition of these controversies

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*Co., v. Fuhrman Petroleum Corp.* 150 S.W.2d 314, 316 (Tex. Civ. App. – El Paso 1941, writ ref'd).

<sup>58</sup> *E.g., Alexander v. Texaco, Inc.*, 482 F.2d 1248, 1252 (5<sup>th</sup> Cir. 1973); *Felber v. Sklar Oil Corp.*, 235 S.W.2d 481, 482 (Tex. Civ. App. – Texarkana 1950, writ ref'd); *Cities Service Oil Co. v. McCrory*, 191 S.W.2d 791, 792 (Tex. Civ. App. – Fort Worth 1945, no writ).

<sup>59</sup> *See Rogers National Bank of Jefferson v. Pewitt*, 231 S.W.2d 487, 489 (Tex. Civ. App. – Texarkana 1950, writ ref'd) (in a trespass to try title action to determine the validity of conflicting oil and gas leases, the owner of a production payment burdening the junior lease, whose interest would be extinguished if the junior lease were held invalid, held to be a necessary and indispensable party to the suit). *But see Standard Oil Company of Texas v. Marshall*, 265 F.2d 46 (5<sup>th</sup> Cir. 1959), *cert. denied*, 361 U.S. 915, 80 S. Ct. 259 (1959) (owner of production payment held not to be an indispensable party to a trespass to try title action, the outcome of which would not have adversely impacted the production payment).

<sup>60</sup> *E.g., Sentinel Oil Co. v. A.E. Herrmann Corp.*, 318 S.W.2d 488, 490 (Tex. Civ. App. – Amarillo 1958, writ dism'd) (production payment is interest in land, so that the proper venue for a suit to remove the production payment as a burden on an oil and gas lease was the county where the land covered by the burdened lease was located); *Humble Oil & Refining Co. v. Monroe*, 129 S.W.2d 454, 455-56 (Tex. Civ. App. – Dallas 1939, no writ).

<sup>61</sup> *E.g., Lockhart v. Williams*, 144 Tex. 553, 192 S.W.2d 146 (1946) (production payment is an interest in land within the meaning of the statute of frauds); *Danciger Oil & Refining Co. v. Christian*, 109 S.W.2d 980 (Tex. Civ. App. – Galveston 1937, writ dism'd).

<sup>62</sup> *E.g., Alamo National Bank of San Antonio v. Hurd*, 485 S.W.2d 335, 341-42 (Tex. Civ. App. – San Antonio 1972, writ ref'd n.r.e.) (devise of “all producing and non-producing oil, gas and mineral royalties, ..., both participating and non-participating, perpetual and term,” held to include a production payment, based on the testator's intent as expressed in the language of the will). *But see State National Bank of Corpus Christi v. Morgan*, 135 Tex. 509, 143 S.W.2d 757, 758-59 (1940) (production payment reserved in an oil and gas lease, although an interest in land, held to constitute additional lease bonus and not to be subject to a conveyance of a non-participating royalty executed prior to the lease).

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<sup>58</sup> *Id.* at 315.

<sup>59</sup> *Id.* at 316.

<sup>60</sup> *Id.* Other courts of civil appeals have reached the same result on similar facts. *E.g., American Liberty Oil Co. v. State*, 197 S.W.2d 381, 382 (Tex. Civ. App. - Fort Worth 1946, writ ref'd n.r.e.); *McCurdy v. Harry L. Edwards Drilling Co.*, 198 S.W.2d 609, 611-12 (Tex. Civ. App. - Galveston 1946, no writ).

<sup>61</sup> As stated by Professor Walker, “On principle there seems little justification for making any distinction between the nature of the property interests created by an oil payment and an overriding royalty, and there can be no doubt in Texas but that an overriding royalty, whether payable in money or by the delivery of oil, is an interest in land.” Walker, *supra* note 15, at 269.

<sup>62</sup> *E.g., State v. Quintana Petroleum Co.*, 134 Tex. 179, 133 S.W.2d 112 (1939), *reh. denied*, 134 Tex. 191, 134 S.W.2d 1016 (1940); *American Liberty Oil Co. v. State*, 197 S.W.2d 381, 383 (Tex. Civ. App. – Fort Worth 1946, writ ref'd n.r.e.); *McLean v. State*, 181 S.W.2d 725, 726-27 (Tex. Civ. App. – Galveston 1944, writ ref'd), *cert. denied*, 324 U.S. 70, 65 S. Ct. 1014 (1945); *Prince Bros. Drilling*

has not frequently required the Texas courts to determine the type of real property interest created.

Professor Walker analyzed the issue as follows:

Applying the analogy that has been made between royalties and rents or profits issuing out of land it would seem that the interest should be regarded simply as an incorporeal hereditament, and, since the interest may possibly endure throughout the life of the determinable fee leasehold estate, it would be a determinable fee incorporeal interest. Manifestly, no present possessory interest is created in the payee, nor can it ever ripen into an interest entitling the payee to possession of the land or of the mineral estate in the future for, so long as the lease continues, the payor-lessee has the right to exclusive possession, and if the leasehold estate terminates the oil payment interest expires with it. This is true even where the oil payment provision expressly undertakes to grant or reserve title to a portion of the minerals.<sup>68</sup>

The limited available Texas case law adopted Professor Walker's analysis that production payments should be characterized as incorporeal, non-possessory interests in real property.<sup>69</sup> Our research has not discovered any cases that consider whether a production payment constitutes a fee simple determinable estate in land. In the absence of specific language in the creating instrument to the contrary, a conventional production payment appears clearly to satisfy the criteria for a fee simple determinable estate in land in the same manner as an oil and gas lease. First, like an oil and gas lease, the grant of such a production payment creates an estate that is capable of enduring forever, and, therefore, one in fee simple.

<sup>68</sup> Walker, *supra* note 15, at 270.

<sup>69</sup> *Standard Oil Co. of Texas v. Marshall*, 265 F.2d 46, 53-54 (5<sup>th</sup> Cir. 1959), *cert. denied*, 361 U.S. 915, 80 S.Ct. 259 (1959) (citing Professor Walker as persuasive authority); *State v. Quintana Petroleum Co.*, 134 Tex. 179, 133 S.W.2d 112, 115 (1939), *reh. denied*, 134 Tex. 191, 134 S.W.2d 1016 (1940). See *Brooks v. Commissioner*, 424 F.2d 116, 122 (5<sup>th</sup> Cir. 1970) ("The production payment owner has no possessory interest, no right to drill, no right to the surface, and no claim to possession. (Cites omitted) His interest is an incorporeal hereditament in the nature of an overriding royalty creating a present interest in the land in the payee.")

Second, the event of special limitation to which the production payment is ordinarily subject - the recovery by the payee of a specified dollar amount or volume of hydrocarbons - may, in fact, never occur. Under this view, the interest retained by the payor is a possibility of reverter which, although vested in interest at the time of its creation, gives the payor no present rights of possession or enjoyment with respect to the production payment.<sup>70</sup>

3. Production Payments in States Other Than Texas. Although we have not attempted to research exhaustively the characterization of production payments under the laws of states other than Texas, we have identified a small number of non-Texas cases addressing this issue that merit discussion.

In California, a state that adheres to the "non-ownership" theory of mineral ownership,<sup>71</sup> the courts have nonetheless characterized mineral, royalty, and leasehold interests in oil and gas, if created for the duration of a freehold,<sup>72</sup> including oil payments,<sup>73</sup> as interests in real property. In New Mexico, a state that, like Texas, has adopted the "ownership in place" theory of mineral ownership,<sup>74</sup> the courts have characterized most types of oil and gas interests,

<sup>70</sup> See *Stephens County v. Mid-Kansas Oil and Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923).

<sup>71</sup> *E.g.*, *Calahan v. Martin*, 3 Cal. 2d 110, 43 P.2d 788 (1935); *Dabney v. Edwards*, S. Cal. 2d 1, 53 P.2d 962 (1936). Under the "non-ownership" theory of mineral ownership, which is premised on the view that oil and gas in place is migratory or fugitive, oil and gas cannot be owned until it is produced, and anyone with the right to drill a well on the land from which the oil and gas is produced may "capture" the produced oil and gas if it is able to do so. See 1 WILLIAMS & MEYERS, *supra* note 4, §203.1 at 33.

<sup>72</sup> See, *e.g.*, *Callahan v. Martin*, 3 Cal. 2d 110, 43 P.2d 788 (1935); *Dabney v. Edwards*, 5 Cal. 2d 1, 53 P.2d 962 (1936); *Payne v. Callahan*, 37 Cal. App. 2d 503, 99 P.2d 1050 (1940); *Enyeart v. Bd. Of Supervisors*, 66 Cal. 2d 728, 58 Cal. Rptr. 733, 537 P.2d 509 (1967); 1 WILLIAMS & MEYERS *supra* note 4, §214 at 160.

<sup>73</sup> *Beshara v. Goldberg*, 221 Cal. App. 2d 392, 34 Cal. Rptr. 501 (1963). *Cf.* *Laugharn v. Bank of America Nat. Trust & Savings Ass'n*, 88 F.2d 551 (9<sup>th</sup> Cir. 1937), *cert. denied*, 301 U.S. 699 (1937) (assignee of "all of the right, title, and interest in and to all crude oil, gas, and other hydrocarbon substances produced from" a well held to be vested with title to an interest in real property in the nature of a mortgage under applicable California statutes).

<sup>74</sup> See 1 WILLIAMS & MEYERS, *supra* note 4, §203.3 at 47.

including a net profits interest, as interests in land.<sup>75</sup> Although our research has not discovered a New Mexico case that has directly addressed the characterization of production payments, New Mexico practitioners with whom the author has discussed the issue believe the New Mexico courts would, in similar fashion, characterize production payments created in the form of a grant of a term overriding royalty interest as interests in real property.

Under Kansas law, on the other hand, while a mineral interest severed from the surface estate is viewed as a separate, corporeal estate in real property, rather than personal property, oil and gas leases and the leasehold estates created thereby, as well as all interests carved out of the leasehold estate, are characterized as in corporeal interests in personal property, unless expressly required by statute to be treated as real property.<sup>76</sup> Thus, both royalty interests<sup>77</sup> and overriding royalty interests<sup>78</sup> have been held to constitute interests in personal property. Consistent with these holdings, the Supreme Court of Kansas has held that an oral agreement providing for the payment by an oil company to a broker of cash and 20,000 barrels of oil produced from lands covered by an oil and gas lease was not a contract for the sale of real property subject to the statute of frauds, but an executory contract for the sale of oil and gas once severed from the ground constituting goods or personal property.<sup>79</sup> The court refused to characterize

<sup>75</sup> Under New Mexico law, the oil and gas leasehold estate, *see, e.g., Bolack v. Hedges*, 56 N.M. 92, 240 P.2d 844 (1952); royalty interests, *see, e.g., Duvall v. Stone*, 54 N.M. 27, 213 P.2d 212 (1949); overriding royalty interests, *see, e.g., Heath v. Gray*, 58 N.M. 665, 274 P.2d 620 (1954), *overruled on other grounds, Kalosha v. Novick*, 84 N.M. 502, 505 P.2d 845 (1973); and a net profit interest created in the form of a grant of an overriding royalty interest, *Team Bank v. Meridian Oil Inc.*, 118 N.M. 147, 879 P.2d 779 (1994), in each case if created for the duration of a freehold estate, all are characterized as interests in real property. *See* 1 WILLIAMS & MEYERS, *supra* note 4, §214 at 165.

<sup>76</sup> *See* 1 WILLIAMS & MEYERS, *supra* note 4, §214.1 at 172-73.

<sup>77</sup> *E.g. Lathrop v. Eyestone*, 170 Kan. 419, 227 P.2d 136 (1951).

<sup>78</sup> *Campbell v. Nako Corporation*, 195 Kan. 66, 402 P.2d 771 (1965).

<sup>79</sup> *McCrae v. Bradley Oil Co.*, 148 Kan. 911, 84 P.2d 866, 870 (1938). The court gave considerable weight to *Dashko v. Friedman*, 59 S.W.2d 203 (Tex. Civ. App. – Texarkana 1933, no writ), and *Standley v. Graham Production Co.*, 83 F.2d 489 (5<sup>th</sup> Cir. 1936), *cert. denied*, 299 U.S. 593, 57 S. Ct. 115 (1936). *See* notes 28-32, *supra*,

the interest in the 20,000 barrels of oil as an overriding royalty interest, but noted that if it had done so, the overriding royalty interest would likewise constitute personal property.<sup>80</sup> Some years later, however, the Kansas Supreme Court held that a collateral assignment of multiple production payments owned by a borrower as security for a debt constituted a mortgage “whereby real estate may be affected” that was, therefore, subject to Kansas’ recording statute.<sup>81</sup> The court noted that its holding was dictated by the language of the recording statute and was not inconsistent with the Kansas courts’ prior holdings that oil and gas leases and interests therein constitute personal property.<sup>82</sup>

Like Kansas, the Nebraska courts have held that, for purposes of Nebraska’s ad valorem taxation statute, an oil payment is an interest in personal property.<sup>83</sup> In a case concerning the proper method of valuing gas sold and exchanged pursuant to a volumetric production payment transaction for purposes of Wyoming’s severance tax and ad valorem tax statutes, on the other hand, the Wyoming Supreme Court held that the volumetric production payment constituted an interest in real property.<sup>84</sup> Colorado jurisprudence is similar to that of Wyoming.<sup>85</sup>

In Louisiana, Article 16 of the Mineral Code defines the term “mineral rights” to include three basic interests that can be created by a landowner: the mineral servitude, the mineral royalty, and the mineral lease.<sup>86</sup> Article 16 expressly does not exclude the creation of other mineral rights and denominates all mineral rights as “real rights” subject either to prescription of nonuse for ten (10) years or, in the case of a mineral lease, to other rules governing the

and accompanying text; notes 135-142, *infra*, and accompanying text.

<sup>80</sup> 84 P.2d at 869-70.

<sup>81</sup> *National Bank of Tulsa v. Warren*, 177 Kan. 281, 279 P.2d 262, 265 (1955).

<sup>82</sup> 279 P.2d at 265.

<sup>83</sup> *Conway v. County of Adams*, 171 Neb. 677, 107 N.W.2d 418 (1961), 172 Neb. 94, 108 N.W.2d 637 (1961).

<sup>84</sup> *EOG Resources, Inc. v. Dep’t of Revenue*, 2004 WY 35, 86 P.3d 1280, 1282-83 (2004).

<sup>85</sup> *See Grynberg v. Waltman*, 946 P.2d 473, 476-77 (Colo. App. 1996), *cert. denied* (1997) (an overriding royalty interest is “an interest in real property for those purposes which affect the land involved and as a personal property interest for purposes of payments that arise from such interest.”)

<sup>86</sup> La. R. S. 31:16.

duration of its existence.<sup>87</sup> Article 18 of the Mineral Code also characterizes mineral rights as “incorporeal immovables” having situs in the parish where the burdened land is located that are alienable and inheritable and that are subject to the “laws of registry” (recording statute).<sup>88</sup>

The comment to Article 16 of the Mineral Code includes the statement that, “There are many types of transactions which may create interests which should be regarded as mineral rights and, therefore, real rights. For example, a production payment (limited royalty) . . . should be characterized as real right under present law.”<sup>89</sup> Article 126 of the Mineral Code provides that an interest created out of the mineral lessee’s interest – such as an overriding royalty or a production payment – is “dependent on the continued existence of the lease and is not subject to the prescription of nonuse.”<sup>90</sup>

Notwithstanding the Louisiana Mineral Code’s rather straightforward language establishing overriding royalties and production payments as real rights in the nature of incorporeal immovables, the United States Court of Appeals for the Fifth Circuit, applying Louisiana law, has held that, on the facts of the case, a volumetric production payment transaction did not result in the creation of a real right, but rather a mortgage on the grantor’s working interest in the burdened leases.<sup>91</sup>

Although a great many Oklahoma cases appear to characterize various types of oil and gas interests as

interests in real property, leading commentators believe that the better view is that interests in oil and gas, whether a severed mineral or royalty interest or an interest arising from an oil and gas lease (such as an overriding royalty interest), should be characterized as personal property, rather than real property, under Oklahoma law.<sup>92</sup> The Oklahoma production payment cases discovered in our research do not really clarify the point. For example, an older Oklahoma Supreme Court decision characterizes an assignment of an oil payment “to be paid from an undivided one-eighth of seven-eighths working interest” created equitable liens under Oklahoma law but also constituted an “instrument relating to real estate” subject to the Oklahoma recording statute that must be recorded to be valid as to third persons.<sup>93</sup>

Because of the significant differences regarding the characterization of interests in oil and gas adopted by the courts of the different states, we recommend that parties entering into production payment transactions affecting oil and gas leases covering land in states other than Texas obtain opinions from local counsel addressing the legal characterization of a production payment under the laws of the relevant state.

### C. Federal Income Taxation of Production Payments

A complete discussion of the federal income tax consequences of production payments is beyond the scope of this paper. Because of the special income tax treatment that production payments receive, however, it is important for practitioners working on production payment transactions to have a basic understanding of the characterization of production payments under Section 636 of the Tax Code.

1. The Economic Interest Concept. The first issue to be considered in this regard is the concept of the economic interest in minerals in place for federal income taxes purposes. The Treasury Regulations provide that an “economic interest” is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which

<sup>87</sup> Id.

<sup>88</sup> La. R.S. 31:18.

<sup>89</sup> La. R.S. 31:18, Comment. See *Duncan v. Paragon Resources, Inc.*, 417 So. 2d 850 (La. App. 1982) (overriding royalty interest is distinct from a mineral royalty; it is carved out of the oil and gas leasehold and is not subject to prescription for nonuse, but is a real right and an incorporeal immovable). See 1 WILLIAMS & MEYERS, *supra* note 4, §216.2 at 178.10-178.11.

<sup>90</sup> La. R.S. 31:126, codifying prior case law. See *Fontenot v. Sun Oil Co.*, 257 La. 642, 243 So. 2d 783 (1971); *Wier v. Glassel*, 216 La. 828, 44 So. 2d 882 (1950).

<sup>91</sup> *In re Senior-G & A Operating Co. v. Aguillard*, 957 F.2d 1290 (5<sup>th</sup> Cir. 1992). See also *Posey v. Fargo*, 187 La. 122, 174 So. 175, 179-80 (1937) (reservation of oil payment in the amount of \$600, payable “out of oil produced and marketed from any well drilled on said land, the same to be paid out of Assignees’ undivided one-half interest in and to said oil and gas lease” held to be mere evidence of a debt and did not create a lien). See notes 147-150, *infra*, and accompanying text. For a more complete discussion of relevant Louisiana jurisprudence on this subject, see Heintz, *supra* note 2, at 5-24-5-29.

<sup>92</sup> See 1 WILLIAMS & MEYERS, *supra* note 4, §214.2 at 175-78.

<sup>93</sup> *Davis v. Lewis*, 100 P.2d 994, 995-96 (Okla. 1940). See also *Tilney v. Allied Materials Corp.*, 256 P.2d 1110 (Okla. 1953) (oil payment granted in a recorded drilling contract treated as a contract right).

the taxpayer must look for a return of his capital.<sup>94</sup> The concept of economic interest was developed by the courts as a means to determine what kinds of income derived from mineral production and sale are subject to depletion and, correlatively, who is taxable on the income.

Early on, the courts chose to look to the benefits and burdens of economic ownership rather than state property law concepts to make those determinations. The primary benefit of mineral ownership was thought to be the right to share in production if and when production occurs. Thus, to be recognized as a holder of an economic interest in the oil, gas or other minerals in place, the holder must have “acquired, by investment, any interest in the oil in place, and secure[d], by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.”<sup>95</sup> The latter part of the test has been interpreted to preclude any possibility of satisfaction from a source other than depletable production income.<sup>96</sup>

2. Production Payments Pre-TRA '69. Although equally applicable when dealing with other types of non-operating interests (i.e., royalties, overriding royalties, and net profits interests), the economic interest concept has received a great deal of attention in the context of production payments.

The United States Supreme Court first considered the income tax consequences of a production payment in its 1937 decision, *Thomas v. Perkins*.<sup>97</sup> There, the assignors transferred an oil and gas lease in exchange for cash and a reserved production payment payable solely out of a percentage of the oil produced from the transferred interest. The Supreme Court concluded that production attributable to the retained production payment was to be taxed to the assignors rather than assignee.

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<sup>94</sup> Treas. Reg. §1.611-1(b)(1).

<sup>95</sup> *Palmer v. Bender*, 287 U.S. 551, 557 (1933). The economic interest concept is also applied to determine whether transfers of interests in mineral properties give rise to ordinary nondepletable income, ordinary depletable income, or capital gain.

<sup>96</sup> See e.g., *Anderson v. Helvering*, 310 U.S. 404, 60 S. Ct. 952 (1940); *Kirby Petroleum Co. v. Comm'r*, 326 U.S. 599, 604 (1946) (“[e]conomic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil”).

<sup>97</sup> 301 U.S. 655 (1937).

In contrast, the assignor in *Anderson v. Helvering*<sup>98</sup> was found not to have retained an economic interest in the minerals conveyed because he retained something more than a mere right to the production of minerals. The assignor in *Anderson* transferred an interest in minerals, as well as a fee interest in the property itself, and received in exchange cash and the assignee’s agreement to pay an additional \$110,000 from one-half of the proceeds derived from oil and gas produced from the properties and from the sale of fee title to any or all of the land conveyed. According to the Supreme Court:

The reservation of an interest in the fee, in addition to the interest in the oil production... materially affects the transaction.... We are of the opinion that the reservation of this additional type of security for the deferred payments serves to distinguish this case from *Thomas v. Perkins*. . . . *Thomas v. Perkins* must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, *the reserved payments are to be derived solely from the production of oil and gas* [emphasis added].<sup>99</sup>

The Supreme Court’s holdings in *Perkins and Anderson* formed the basis for determining the federal income tax consequences arising from the creation of a production payment prior to the Tax Reform Act of 1969. In the case of an interest payable solely from production, the holder was deemed to have acquired an economic interest in the unproduced minerals and, accordingly, gross income from production applied in satisfaction of the production payment was taxed to the holder of the production payment and the holder was entitled to depletion in respect of that gross income. On the other hand, in the case of an interest payable from a source other than production, the holder was deemed not to have acquired an economic interest in the unproduced minerals. Instead, the holder was treated as having made a loan to the owner of the burdened mineral property who remained taxable on and entitled to depletion in respect of the gross income from production applied in satisfaction of the production payment.

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<sup>98</sup> 310 U.S. 404 (1940).

<sup>99</sup> *Id.* at 412, 413.

In *Commissioner v. P. G. Lake, Inc.*,<sup>100</sup> in exchange for cancellation of a debt owed to its president, the taxpayer assigned to its president an oil payment right “carved out” of its working interest equal to the principal amount of the debt, plus an interest factor. The right was payable solely out of a percentage of the oil attributable to taxpayer’s retained working interest, and it paid out as anticipated in a little more than three years. The taxpayer treated the “carved out” production payment as a sale giving rise to a long-term capital gain. Focusing on the character of the income that the taxpayer otherwise would have received had it *retained* the interest and satisfied the debt owed its president with proceeds derived from the sale of production, the Supreme Court held that the “carved out” production payment was a mere anticipatory assignment of future ordinary income.<sup>101</sup>

*Perkins* and *Lake* spawned a form of abuse in what came to be known as the “A-B-C” transaction. In a typical A-B-C transaction, A, the lessee under an oil and gas lease and the owner of the working interest in the underlying minerals, conveyed the working interest to B for cash, retaining a production payment for most of the purchase price. A immediately sold the retained production payment to C (usually, a financial purchaser or tax-exempt organization). C’s purchase price was often entirely financed with a bank loan secured by the production payment. Because A had disposed of its entire interest in the property, A realized a capital gain on the sale (the ordinary income rationale of *Lake* did not apply because A did not *transfer* a production payment carved out of a larger interest; rather, A *retained* the production payment upon transfer of the working interest and thereafter sold his entire retained interest to a third party). Under *Perkins*, the production payment held by C was treated as an economic interest in the minerals, and C rather than B was taxable on the gross income applied in satisfaction of the production payment. Thus, the A-B-C transaction allowed B to repay what was economically equivalent to a nonrecourse purchase money mortgage loan with pre-tax income.<sup>102</sup>

3. TRA ’69 and Section 636. Congress’ passage of the Tax Reform Act of 1969 (“TRA ’69”)<sup>103</sup>

<sup>100</sup> 356 U.S. 260, 78 S. Ct. 691 (1958).

<sup>101</sup> *Id.* at 265, 266.

<sup>102</sup> See, generally, Leggett, *Production Payment Tax Issues*, 45<sup>th</sup> OIL & GAS INST. 16-1, 16-5, 16-7 (Matthew Bender 1994) (hereinafter, “Leggett”); Bullion, *The ABC Deal: Is There A Reasonable Facsimile?*, 22<sup>nd</sup> OIL & GAS INST. 179, 179-82 (Matthew Bender 1971).

<sup>103</sup> Pub. L. 91-172, 83 Stat. 487.

effectively ended the perceived tax abuses resulting from A-B-C transactions through the enactment of new Section 636 of the Tax Code.<sup>104</sup> Under Section 636, production payments are generally no longer taxed as economic interests in the hands of their owners, but as mortgage loans.<sup>105</sup> Thus, in the case of a production payment carved out of the leasehold estate that is not specifically pledged for exploration or development operations, the consideration paid by the holder of the production payment to the grantor is treated as a mortgage loan to the grantor, and, therefore, not included in the grantor’s gross income. All production and related proceeds attributable to the production payment are treated as ordinary income to the grantor, subject to depletion. The holder of the production payment is treated as if the amounts received pursuant to the production payment are principle and interest received in repayment of a loan. The portion of the amounts received representing interest are includable in the holder’s gross income.<sup>106</sup>

Similarly, a production payment reserved in a sale of an oil and gas leasehold interest will be treated as a purchase money mortgage loan encumbering the property burdened by the production payment.<sup>107</sup> The fair market value of the production payment will be treated as part of the purchase price received by the mineral property seller who retains the production payment for purposes of calculating his gain on the sale.<sup>108</sup> Amounts received by the mineral property transferor from the retained production payment are treated as payments of principle and interest received in payment of the deemed purchase money loan.<sup>109</sup> The purchaser of the mineral property receives an economic interest in the entirety of the transferred oil and gas leasehold interest, including the portion burdened by the production payment, so that all proceeds attributable to the production payment are ordinary income to the purchaser of the mineral property, subject to depletion.<sup>110</sup> A production

<sup>104</sup> H.R. Rep. No. 413, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 138 (1969), 1969-3 C.B. 200, 288; S. Rep. No. 552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 182-183 (1969), 1969-3 C.B. 423, 540. See Leggett, *supra* note 102, at 16-6, 16-7.

<sup>105</sup> See, generally, Leggett, *supra* note 102 at 16-7; Berry, *Section 636 - Production Payments*, 25<sup>TH</sup> OIL & GAS INST. 389 (Matthew Bender 1974).

<sup>106</sup> I.R.C. §636(a); Treas. Reg. §§1.636-1(a)(1)(i) and (ii).

<sup>107</sup> I.R.C. §636(b).

<sup>108</sup> Treas. Reg. §§1.636-2(a), 1.636-2(c)(5)(ii).

<sup>109</sup> Treas. Reg. §1.636-1(c)(1)(i).

<sup>110</sup> Treas. Reg. §1.636-1(a).

payment reserved by a lessor in a leasing transaction is treated as an installment lease bonus, so that the lessor includes the proceeds attributable to the production payment in his gross income in the year received, subject to cost depletion.<sup>111</sup>

The only circumstance in which a production payment retains its pre-TRA '69 tax treatment is one in which a carved-out production payment is expressly pledged to finance the development of a property for oil and gas. In that case, the production payment is treated as an economic interest in the hands of the holder thereof, so that the proceeds attributable to the production payment are depletable ordinary income to the holder, rather than the grantor.<sup>112</sup>

4. Tax Definition of Production Payments. Section 636 and its implementing regulations did not change the historical definition of a production payment.<sup>113</sup> Under the current Treasury Regulations, all production payments are defined by reference to the following elements:

- the production payment must provide for the right to a specified share or percentage of production (if, as, and when produced) or the proceeds from the sale thereof;<sup>114</sup>
- the production payment must be limited in duration, whether by amount of money received, volume of hydrocarbons produced, or defined period of time;<sup>115</sup>
- the production payment must be an economic interest in minerals in place;<sup>116</sup>
- the production payment may not be satisfied from any source other than production or the

proceeds from the sale thereof. If the production payment may be satisfied by any means other than production, it is not an economic interest and will not be treated as a production payment for federal tax purposes (the “Alternative Source Rule”);<sup>117</sup>

- except in the case of a production payment pledged for exploration and production, a production payment may burden more than one property as defined in Section 614 of the Tax Code.<sup>118</sup>
- the production payment must have an expected economic life, at the time of its creation, of shorter duration than the economic life of the property it burdens. A right to mineral in place has an economic life of shorter duration than the economic life of the mineral property burdened thereby only if the right is not reasonably expected to extend in substantial amounts over the entire productive life of the mineral property.<sup>119</sup> In this regard, the Internal Revenue Service will consider issuing an advance ruling that an interest in minerals is a production payment under Section 636 if (i) it is reasonably expected, at the time of creation, that the production payment will terminate upon the

<sup>111</sup> I.R.C. §636(c); Treas. Reg. §1.636-2(a).

<sup>112</sup> I.R.C. §636(a). The exception from mortgage loan treatment incorporated prior law holding that, under the “pool of capital” doctrine, the transfer of a production payment in exchange for a contribution to the exploration and development of the burdened property was not a “realization event” for the transferor but, instead, a capital investment by the transferee in the development of the mineral property. See G.C.M. 22,730, 1941-1 C.B. 214; Leggett, *supra* note 102, at 16-13.

<sup>113</sup> See, e.g., *Christie v. United States*, 436 F.2d 1216, 1217 (5<sup>th</sup> Cir. 1971) (“A production payment is a right to minerals in place that entitles its owner to a specified fraction of production for a limited period of time or until a specified sum of money or a specified number of units of oil or gas has been produced.”).

<sup>114</sup> Treas. Reg. § 1.636-3(a)(1).

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* See, e.g., *Anderson v. Helvering*, 310 U.S. 404, 412-13, 60 S.Ct. 952, 956-57 (1940) (production payment payable out of production proceeds *and* proceeds from the sale of fee title to related lands *held* not to be an economic interest); *Herbel v. Comm’r*, 637 F.2d 1041 (5<sup>th</sup> Cir. 1981) (guaranteed payments received by taxpayer in settlement of a take-or-pay contract did not constitute economic interests and, therefore, production payments); *Christie v. United States*, 436 F.2d 1216, 1220-21 (5<sup>th</sup> Cir. 1971) (production payment payable out of production proceeds *and* the salvage value of certain surface equipment *held* not to be an economic interest); *Comm’r v. Donnell*, 417 F.2d 106, 115-16 (5<sup>th</sup> Cir. 1969) (production payment personally guaranteed by take-out letter *held* not to be an economic interest). See 2 WILLIAMS & MEYERS, *supra* note 4, §423.10 at 411-15.

<sup>118</sup> Treas. Reg. 1.636-3(a)(i). See G.C.M. 32,478 (Jan. 3, 1963); G.C.M. 39, 181 (March 6, 1984); T.A.M. 82-48-011 (August 31, 1982); T.A.M. 83-02-016 (October 5, 1982); P.L.R. 83-12-019 (December 5, 1982).

<sup>119</sup> Treas. Reg. §1.636-3(a)(1). See *United States v. Morgan*, 321 F.2d 781 (5<sup>th</sup> Cir. 1963). (The economic life test is met if (i) an ordinary prudent oil and gas operator could reasonably expect, at the time of creation of the right, that the specified sum would be paid out before the expiration of the burdened lease, and (ii) at the time of the creation of the right, the person retaining it actually has such an expectation).

production of not more than 90% of the reserves then known to exist, and (ii) the present value of the production expected to remain after the production payment terminates is 5% or more of the present value of the entire burdened property, determined at the time of creation.<sup>120</sup>

In addition, a right that is “in substance economically equivalent to a production payment” will be treated as a production payment for purposes of Section 636, regardless of the language used, the method of creation, or the form of the transaction, even if designated as an operating mineral interest.<sup>121</sup>

The failure of a production payment to satisfy any of the foregoing definitional elements will have serious tax consequences for any production payment transaction. If, for example, the production payment

<sup>120</sup> Rev. Proc. 97-55, 1997-2 C.A. 582. Although the regulations under Section 636 of the Tax Code contemplate that a production payment may burden a non-producing mineral property, the taxpayer faces a high burden of proof that such a production payment satisfies the economic life test. See *Yates v. Comm’r*, 92 T.C. 1215 (1989), *aff’d*, 924 F.2d 967 (10<sup>th</sup> Cir. 1991), in which the Tenth Circuit stated that, in determining whether an undeveloped property satisfied the economic life test,

all relevant circumstances must be examined. Relevant circumstances would include numerous factors such as available geologic and seismic information; the cost of lease acquisition; the costs of exploring, drilling and producing; the price of oil and the price of its treatment and transportation costs; the probable pay-out; the prices received by the taxpayer; the proximity of production as well as many other factors. It would be a rare case if any one or two of these factors were alone controlling.

924 F.2d at 971-72. The court characterized the taxpayer’s burden of persuasion as “difficult”, but not impossible. *Id.* at 972. See Leggett, *supra* note 102, at 16-34-16-42.

<sup>121</sup> Treas. Reg. 1-636-3(a)(2). The Regulations give the following example. In a variable royalty situation, that portion of a royalty that exceeds the lowest possible rate of the royalty at any subsequent time, disregarding any reductions based solely on changes in production volume within a period not exceeding one year, are treated as a production payment. Thus, in the case of a mineral royalty equal to 5% for five years and 4% thereafter, the 1% reduction is considered a production payment. *Id.*

does not qualify as an economic interest, the failed production payment would likely be treated as a secured loan for tax purposes.<sup>122</sup> Obviously, this would be a very undesirable result for a carved-out production payment pledged for exploration and development. Alternatively, if secured debt treatment does not apply, treatment as an advance payment for goods – like a forward sale of gas, for example – might apply.<sup>123</sup>

5. Production Payments Pledged for Exploration or Development. In addition to satisfying the definitional elements of a production payment discussed above, the grantor in a carved-out production payment pledged for exploration or development must specifically pledge to use the proceeds of the production payment solely for exploration or development of the mineral property burdened by the production payment (and no other property).<sup>124</sup> So-called “blanket” production payments – interests burdening multiple oil and gas leases – do not qualify for the exploration and development exception under Section 636. For purposes of Section 636, the term “mineral property” has the same meaning assigned to the term “property” in Section 614(a) (“each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land”).<sup>125</sup>

An expenditure is for exploration or development if necessary for “ascertaining the existence, location, extent or quality of any deposit of mineral or is incident to and necessary for the preparation of a deposit for the production of minerals.” Conversely, an expenditure relating primarily to the production of minerals, such as for a waterflood program, is not for exploration or development.<sup>126</sup> A facts and circumstances test is used in determining whether an expense is for exploration or development. A production payment will fail to satisfy the exception if the payment:

<sup>122</sup> See *Lehigh Portland Cement Co. v. United States*, 433 F. Supp. 639 (D.C. Pa. 1977), *aff’d without opinion*, 78-2 U.S.T.C. ¶ 9498 (3d Cir. 1978); *Dillingham v. United States*, 81-2 U.S.T.C. ¶ 9601, 71 O.&G.R. 633 (W.D. Okla. 1981); *Estate of Donnell v. Comm’r*, 48 T.C. 552, 568 (1967), *aff’d in part, rev’d in part*, 417 F.2d 106 (5<sup>th</sup> Cir. 1969). See also Leggett, *supra* note 102, at 16-18, 16-19.

<sup>123</sup> See Rev. Rul. 84-31, 1984-1 C.B. 127; Leggett, *supra* note 102, at 16-19.

<sup>124</sup> Treas. Reg. § 1.636-1(b)(1); T.A.M. 81-25-001 (December 24, 1980).

<sup>125</sup> I.R.C. § 636(d).

<sup>126</sup> Treas. Reg. § 1.636-1(b)(1).

- (a) is not pledged for use in the future exploration or development of the mineral property burdened by the production payment;
- (b) may be used for the exploration or development of any other property or for any other purpose;
- (c) does not consist of a binding obligation of the payee of the production payment to pay such exploration or development expenses; or
- (d) does not consist of a binding obligation of the payee of the production payment to provide services, materials, supplies, or equipment for such exploration or development.<sup>127</sup>

#### D. Bankruptcy Treatment of Production Payments.

One of the primary benefits of utilizing production payments in financing transactions is the favorable treatment, from the perspective of the production payment holder, that such interests receive under the United States Bankruptcy Code<sup>128</sup> (“Bankruptcy Code”) in the event of the bankruptcy of the production payment grantor. The critical inquiry in this regard is whether the production payment is treated as property of the estate of the grantor, as debtor, when the grantor’s case in bankruptcy commences. Once again, there is some history to review.

1. Bankruptcy Code Section 541 – Generally. Section 541 of the Bankruptcy Code defines property of the debtor’s estate to consist of “all legal or equitable interests of the debtor in property as of the commencement of the case.” The United States Supreme Court has construed the quoted language from Section 541 to mean that that property of the estate of the debtor is property owned by the debtor upon the filing of the petition in bankruptcy.<sup>129</sup>

The trustee or debtor-in-possession may, of course, rely on specific Bankruptcy Code provisions that expand its rights over those held by the debtor prior to the filing of the petition. Absent some such specific Bankruptcy Code provision, however, the rights of the trustee are the same as the rights of the debtor prior to bankruptcy. As stated in the comments to Section 541 contained in the legislative history of the Bankruptcy Code:

[T]his paragraph . . . is not intended to expand the debtor’s right against

<sup>127</sup> *Id.*

<sup>128</sup> 11 U.S.C. §§ 1, *et seq.* (West 2010).

<sup>129</sup> *U.S. v. Whiting Pools Inc.*, 462 U.S. 198, 103 S.Ct. 2309, 2313-14, 2316-17 (1983).

others more than they exist at the commencement of the case. [T]he trustee . . . could take no greater rights than the debtor himself had.<sup>130</sup>

This reasoning has consistently been applied by the courts.<sup>131</sup>

Neither the former Bankruptcy Act nor, prior to the Bankruptcy Reform Act of 1994 (“BRA ‘94”),<sup>132</sup> the current Bankruptcy Code provided rules for determining whether a production payment constituted a property interest in the hands of the holder or evidence of a debt of the grantor/debtor and, therefore, property of the grantor/debtor’s estate. It was always necessary to use state law to determine ownership of property of the estate.<sup>133</sup>

In this regard, the courts have consistently adhered to the principle that “to the law of the state in which the land is situated we must look for the rules which govern its descent, alienation, and transfer, and for the effect and construction of wills and other conveyances.”<sup>134</sup>

2. Case Law. Based largely on the early, pre-*Sheffield* struggles of the Texas courts, to determine the proper characterization of royalty and overriding interests under Texas law, early attempts by the federal courts to characterize production payments for bankruptcy purposes were similarly inconsistent. For example, in *Standley v. Graham Production Co.*,<sup>135</sup> the United States Court of Appeals for the Fifth Circuit held that the conveyance as a production payment of “an undivided one-fourth (1/4) of seven-

<sup>130</sup> H.R. No. 95-595, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1977) 367-8, U.S. CODE CONG. AND ADMIN. NEWS 1978 at 6323.

<sup>131</sup> *E.g.*, *South Central Livestock v. Security State Bank*, 614 F.2d 1056, 1061 (5th Cir. 1980) (“One elementary rule of bankruptcy, however, is that the trustee succeeds only to the title and rights in the property that the debtor possessed.”); *Georgia Pacific Corp. v. Sigma Service Corp.*, 712 F.2d 962, 968 (5th Cir. 1983); *Matter of Paderewski*, 564 F.2d 1353, 1356 (9th Cir. 1977) (“The [former] Bankruptcy Act generally does not vest the trustee with any better right or title to the bankrupt’s property than the bankrupt had at the moment of bankruptcy.”)

<sup>132</sup> Pub. L. No. 103-394, 103<sup>rd</sup> Congress (1994).

<sup>133</sup> *Butner v. U.S.*, 440 U.S. 48, 99 S.Ct. 914, 918 (1979). *See* 4 COLLIER ON BANKRUPTCY §541.07[1] at 451-29 (Matthew Bender 2010).

<sup>134</sup> *DeVaughn v. Hutchinson*, 165 U.S. 566, 17 S.Ct. 461, 462 (1897). *See Brown v. Comm’r*, 1 80 F.2d 946, 950 (5<sup>th</sup> Cir. 1950).

<sup>135</sup> 83 F.2d 489 (5th Cir. 1936), *cert. denied*, 299 U.S. 593, 57 S.Ct. 115 (1936).

eights (7/8) of all of the first oil/or gas produced, saved and marketed from the above described leasehold estate, if, as and only when same is produced, saved and marketed therefrom” until the payee recovered the sum of \$20,000.00, did not create an estate in land, but only a lien on the hydrocarbons after their production. As a result, the production payment remained a part of the estate of the assignor when the assignor filed its petition in bankruptcy, and the assignee was left with only a claim against its assignor’s estate that was subordinate to the prior claims of the assignor’s creditors. In so holding, the Fifth Circuit cited as controlling authority the Texas Court of Civil Appeals decision in *Dashko v. Freidman*,<sup>136</sup> in which the court had relied upon the phrase “as, if and when produced” to conclude that the parties intended to convey only a personal property interest in the hydrocarbons after their production.<sup>137</sup>

The Fifth Circuit reached a completely different result on similar facts in the case of *Berry v. Harrell*,<sup>138</sup> decided on the same date as *Standley*. Although the printed opinion does not reproduce the exact language creating the production payment in controversy, the payee appears to have received an undivided 7/32 interest in the leasehold estate until the payee recovered \$10,000.00 out of the first oil or gas produced therefrom. As had been the case in *Standley*, the grantor of the production payment went into receivership, the receiver sold the lease burdened by the production payment, asserting that such sale was free of such interest, and the payee filed suit to establish his ownership with respect thereto. The court held that the production payment conveyance had vested the payee with title to an interest in land until the termination thereof in accordance with its terms and that the payee was not divested of his interest by the receiver’s sale.<sup>139</sup> Professor Walker discussed the apparently tenuous grounds for distinguishing the two cases as follows:

Perhaps, in the *Berry* case the instrument creating the oil payment was actually in the form of an assignment of a fractional interest in the lease, as might be inferred from the opinion, until the sum of \$10,000 was realized from the production; or

<sup>136</sup> 59 S.W.2d 203 (Tex. Civ. App. - Texarkana 1933, no writ).

<sup>137</sup> See notes 28-32, *supra*, and accompanying text.

<sup>138</sup> 83 F.2d 671 (5<sup>th</sup> Cir. 1936), *cert. denied*, 299 U.S. 559, 57 S.Ct. 21 (1936).

<sup>139</sup> *Id.* at 673.

it may be that the instrument did not use the language “if, as and only when same is produced,” to which the court apparently attached so much importance in the *Standley* case. In any event these seem to be the only possible grounds upon which to distinguish the two cases.<sup>140</sup>

As discussed above in this paper,<sup>141</sup> subsequent Texas decisions clearly have repudiated the analytical approach to the characterization of production payments represented by cases such as *Dashko*. Because the Fifth Circuit in *Standley* cited the *Dashko* case as controlling precedent, the validity of the reasoning in the *Standley* case should have suffered just as much damage at the hands of the subsequent Texas decisions as that in *Dashko*.<sup>142</sup>

No reference to *Standley* appears in *Terry Oilfield Supply Co., Inc. v. American Security Bank*,<sup>143</sup> a 1996 bankruptcy court case out of the Southern District of Texas. In *Terry*, the plaintiff, a drilling contractor in 1984 and 1987 entered into two drilling contracts with a gas producer operating as a debtor-in-possession in bankruptcy, pursuant to which the plaintiff accepted a conveyance of a production payment and an assignment of rights under an existing, highly favorable gas sales contract covering the leases burdened by the production payment.<sup>144</sup> In holding that the plaintiff was entitled, by virtue of the assignment of contract rights, to participate in the proceeds of a settlement between the producer and the gas purchaser that terminated the referenced gas sales contract,<sup>145</sup> the bankruptcy court concluded that the production payment was an interest in real property owned by the plaintiff, and not property of the gas producer/debtor’s estate in bankruptcy.<sup>146</sup>

<sup>140</sup> Walker, *supra* note 15, at 264.

<sup>141</sup> See notes 28-32, *supra*, and accompanying text.

<sup>142</sup> Please note, however, that *Standley* has never been expressly overruled. Indeed, *Standley* was cited in at least two cases decided in the 1980s as controlling authority for the proposition that, for purposes of notices to creditors concerning the proposed sale of a debtor’s property, letters duly mailed are presumed to have been received by the addressees. See *In re Worthing*, 24 B.R. 774, 777 n.8 (D. Conn. 1982); *A.H.L. Properties #1 v. Central National Bank of Houston*, 647 S.W.2d 366 (Tex. App. - Corpus Christi 1982, no writ).

<sup>143</sup> 195 B.R. 66 (S.D. Tex. 1996).

<sup>144</sup> *Id.* at 70.

<sup>145</sup> *Id.* at 69.

<sup>146</sup> *Id.* at 70-71, 74.

Once again, we note, however that the Fifth Circuit reached a different result in *In re Senior-G&A Operating Co. v. Aguillard* (“*Senior-G&A*”),<sup>147</sup> an appeal of a bankruptcy court decision out of the Western District of Louisiana. In *Senior-G&A*, the debtor-in-possession, prior to the commencement of its bankruptcy in 1988, entered into an agreement with the plaintiff styled “Production Payment Loan Agreement”, pursuant to which the debtor-in-possession sold and conveyed to the plaintiff a production payment for cash.<sup>148</sup> Applying Louisiana law, the Fifth Circuit affirmed the bankruptcy court’s decision that the plaintiff was a secured creditor in the bankruptcy of the debtor-in-possession, rather than the transferee of a production payment in the nature of a real right.<sup>149</sup> In so holding, the Fifth Circuit cited as key factors in its decision: (a) the title of the base agreement as a “Production Payment *Loan Agreement*” (emphasis added); (b) the statements in that agreement that the “Production Payment granted hereby shall constitute a lien upon the Subject Materials covered hereby”; (c) the presence of a lien against the oil and gas leasehold interests burdened by the production payments to secure the debtor-in-possession’s performance of numerous covenants in the transaction documents that, if foreclosed, would have given the plaintiff the right to take over oil and gas operations on the burdened leases; and (d) the right of the plaintiff to take in kind the share of production from the burdened leases attributable to the production payment.<sup>150</sup>

3. Effect of BRA ’94. The BRA ’94 added to the Bankruptcy Code new Section 541(b)(4),<sup>151</sup> which should reduce the conflicting results regarding the treatment of production payments in bankruptcy with respect to cases commenced after 1994. Pursuant to Section 541(b)(4)(B), there is now expressly excluded from the property of a debtor’s estate in bankruptcy “any interest of the debtor in liquid or gaseous hydrocarbons to the extent that -- . . .

(B)(i) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from

which such production payment is transferred; and

(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 542 of this title; . . .”<sup>152</sup>

For purposes of Section 541(b)(4)(B), the term “production payment” means “a term overriding royalty satisfiable in cash or in kind” that is “(A) contingent on the production of a liquid or gaseous hydrocarbon from particular real property”, and “(B) from a specified volume, or a specified value, from the liquid or gaseous hydrocarbon produced from such property, and determined without regard to production costs.”<sup>153</sup> The term “term overriding royalty” is defined as “an interest in liquid or gaseous hydrocarbons in place or to be produced from particular real property that entitles the owner thereof to a share of production, or the value thereof, for a term limited by time, quantity, or value received.”<sup>154</sup>

Section 541(b)(4)(B) of the Bankruptcy Code was not in effect when the bankruptcies at issue in *Terry* and *Senior-G&A* were commenced. Going forward, Section 541(b)(4)(B) should produce far more consistent bankruptcy court characterizations of production payments, at least with respect to production payments that would receive mortgage loan treatment for federal income tax purposes under Section 636 of the Tax Code. The phrase “to an entity that does not participate in the operation of the property”, appearing in Section 541(b)(4)(B)(i), appears, however, to exclude from the scope of Section 541(b)(4)(B), whether intentionally or not, production payments utilized by producers to obtain vendor financing of exploration and development activities on the burdened leases, like the production payment analyzed in *Terry*.<sup>155</sup> Based on our research, we have not discovered any cases interpreting the scope of Section 541(b)(4)(B) of the Bankruptcy Code, so it is unclear whether Congress intended to change prior law with respect to the bankruptcy treatment of this category of production payments.<sup>156</sup> Until this issue is addressed by the courts, we have no reason to believe that *Terry* is not still good law with

<sup>147</sup> 957 F.2d 1290 (5<sup>th</sup> Cir. 1992).

<sup>148</sup> *Id.* at 1293.

<sup>149</sup> *Id.* at 1297.

<sup>150</sup> *Id.* at 1296-97.

<sup>151</sup> 11 U.S.C.A. §541(b)(4) (West 2010).

<sup>152</sup> *Id.* at § 541(b)(4)(B).

<sup>153</sup> 11 U.S.C.A. § 101(a)(1)(42A) (West 2000).

<sup>154</sup> 11 U.S.C.A. § 101(a)(1)(56A) (West 2000).

<sup>155</sup> See notes 143-146, *supra*, and accompanying text.

<sup>156</sup> See Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, 5 TEXAS J. OIL, GAS & ENERGY L. 265, 284 (2009-10).

respect to production payments used for vendor financing purposes.

### E. Accounting Treatment of Production Payments.

While Section 636 of the Tax Code establishes two different possible treatments for production payments,<sup>157</sup> there are at least five possible accounting treatments available for production payments. The basic requirements for the financial accounting treatment of production payments are set forth in Statement of Financial Accounting Standards No. 19, as amended,<sup>158</sup> which have also been incorporated by reference into the regulations of the Securities and Exchange Commission governing financial accounting and reporting for oil and gas producing activities under Regulation S-X.<sup>159</sup>

A complete review of all accounting principles applicable to production payments is beyond the scope of this paper. Here, then, is a brief review of the basic concepts:

- If an operator sells a dollar-denominated production payment for cash, the transaction will be accounted for as a borrowing, with the grantor of the production payment carrying the amount of the production payment as an account payable on its books, and the holder of the production payment carrying the amount of the cash paid for the production payment as an account receivable on its books. The oil and gas reserves attributable to the production payment are retained on the books of the grantor.<sup>160</sup>
- If an operator sells a volumetric production payment for cash, the transaction is accounted for as a sale of a mineral interest. The grantor does not recognize gain on the sale because it “has a substantial obligation for future performance,” and accounts for the funds received in the sale as unearned revenue to be recognized as the oil or gas is delivered. The holder of the production payment is treated as having acquired an interest in minerals that is

<sup>157</sup> See notes 103-112, *supra* and accompanying text.

<sup>158</sup> Statement of Financial Accounting Standards No. 19 (FASB 2008), as amended (as amended, “FAS No. 19”). The embedded derivative provisions of FASB Statement of Financial Accounting Standards No. 133 also apply to the accounting by all parties for a volumetric production payment for which the quantity of the commodity to be delivered is reliably determinable.

<sup>159</sup> Regulation S-X, 17 C.F.R. § 210.4-10(b)(2010).

<sup>160</sup> FAS No. 19, ¶ 43.b.

recorded on its books at cost and amortized by the unit-of-production method as delivery takes place. The reserves attributable to the production payment are carried on the books of the holder.<sup>161</sup>

- If a producer sells an oil and gas property for cash and retains a dollar-denominated production payment, and the satisfaction of the retained production payment is “reasonably assured”, the seller of the oil and gas property records the transaction as a sale, subject to recognition of resulting gain or loss, and carries the retained production payment on its books as an account receivable. The buyer of the oil and gas property records, as the cost of the property purchased, the cash consideration paid plus the present value of the retained production payment, which the buyer carries on its books as an account payable. The buyer also carries on its books all of the reserves attributable to the purchased oil and gas property, including those attributable to the retained production payment.<sup>162</sup>
- In the preceding scenario, if the satisfaction of the retained production payment is “not reasonably assured”, “the transaction will be treated as a sale of an asset by the grantor with a retained overriding royalty, with the grantor recognizing any resulting gain or loss. The grantor allocates the cost of the oil and gas property to the operating interest sold and the non-operating interest retained based on their respective fair values.<sup>163</sup>
- Finally, if a producer sells an oil and gas property for cash and retains a dollar-denominated production payment, the transaction will be treated as a sale of an asset by the grantor with a retained overriding royalty as described in the immediately preceding scenario.<sup>164</sup>

### F. Environmental Issues.

There are numerous federal and state environmental statutes that potentially affect oil and gas operations.<sup>165</sup> To date, our research has not

<sup>161</sup> Id. at ¶47.a.

<sup>162</sup> Id. at ¶47.1.i.

<sup>163</sup> Id. at ¶¶ 47.1.ii and 47.k.

<sup>164</sup> Id. at ¶¶ 47.m and 47.k.

<sup>165</sup> See, e.g., the Clean Air Act, 42 U.S.C.A. §§7401, *et seq.* (West 2010); the Oil Pollution Act of 1990 (“OPA

discovered any case that definitively establishes whether the owner of a non-operating interest in oil and gas – such as a royalty interest, overriding royalty interest, or production payment – can be held liable under any of these statutes. This absence of case law is probably due, in no small part, to the fact that crude oil and ordinary oilfield wastes are excluded from the lists of “hazardous” substances covered by many of such statutes.<sup>166</sup> An analysis of the potential exposure of a production payment holder under all of the various environmental statutes is well beyond the scope of this paper. A brief discussion of the issue in the context of the Comprehensive Environmental Response, Compensation and Liability Act, as amended (“CERCLA”),<sup>167</sup> will be instructive, however.

1. CERCLA Liability-Generally. CERCLA imposes liability for the “release or threatened release”<sup>168</sup> of “hazardous substances”<sup>169</sup> from a “facility”<sup>170</sup> by: (a) the owner or operator of a vessel or facility; (b) any person who, at any time when hazardous substances were disposed of, owned or operated the facility; (c) any person who, contractually or otherwise, “arranged” for the disposal, treatment, or transport of a hazardous substance; and (d) any person who accepts hazardous substances for transport to disposal facilities.<sup>171</sup> For purposes of the statute, a “person” includes, *inter alia*,

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“90”), 33 U.S.C.A. §§2701-2761 (West 2010); the Federal Water Pollution Control Act (“FWPCA”), 33 U.S.C.A. §§1251-1387 (West 2010); the Clean Water Act, 33 U.S.C.A. §§1251, *et seq.* (West 2010); the Solid Waste Disposal Act of 1970, as amended by the Resource Conservation and Recovery Act of 1976, 42 U.S.C.A. §§6901, *et seq.* (West 2010); the Texas Solid Waste Disposal Act, TEX. HEALTH & SAFETY CODE ANN. §§361.001, *et seq.* (Vernon 2010); and the Texas Clean Air Act, TEX. HEALTH & SAFETY CODE ANN. §§382.001, *et seq.* (Vernon 2010).

<sup>166</sup> See Cope, *Environmental Liabilities of Non-Operating Parties*, 37 ROCKY MT. MIN. L. INST. 1-1, 1-3 (1991) (hereinafter, “Cope”).

<sup>167</sup> Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended by the Superfund Amendments and Reauthorization Act of 1986, 42 U.S.C.A. §§9601-9675 (West 2010).

<sup>168</sup> 42 U.S.C.A. § 9601(22) (West 2005 and Supp. 2010).

<sup>169</sup> *Id.* at § 9601(14).

<sup>170</sup> *Id.* at § 9601(9).

<sup>171</sup> *Id.* at § 9607(a).

individuals, corporations, firms, associations, partnerships, joint ventures, and governmental authorities and entities;<sup>172</sup> and a “facility” includes “any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located.”<sup>173</sup> CERCLA liability is strict and joint and several, unless the environmental harm is divisible.<sup>174</sup>

2. Petroleum Exclusion. Specifically excluded from CERCLA’s definition of “hazardous substances” are “petroleum, including crude oil or any fraction thereof not otherwise specifically listed or designated as a hazardous substance, natural gas, natural gas liquids, liquefied natural gas, or synthetic gas useable as fuel.”<sup>175</sup> Benzene, ethylbenzene, toluene, and xylene are specifically defined as “hazardous substances.”<sup>176</sup> This is commonly referred to as the “petroleum exclusion” under CERCLA. In addition, the Resources Conservation and Recovery Act (“RCRA”)<sup>177</sup> exempts from regulation as hazardous substances “drilling fluids, produced waters, and other wastes associated with the exploration, development or production of crude oil or natural gas or geothermal energy” when present at a production site, but not elsewhere.<sup>178</sup> This is commonly referred to as “drilling waste exclusion” from RCRA. Between these two exclusions, releases common to most onshore oil and gas exploration, development, and production activities are exempt from federal environmental regulation under CERCLA and RCRA.

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<sup>172</sup> *Id.* at § 9601(21).

<sup>173</sup> *Id.* at § 9601(9).

<sup>174</sup> See, e.g., *United States v. Monsanto Co.*, 858 F.2d 160, 167 n. 11 (4th Cir. 1988), *cert. denied*, 490 U.S. 1106 (1989); *Tanglewood East Homeowners v. Charles Thomas, Inc.*, 849 F.2d 1568, 1572 (5th Cir. 1988).

<sup>175</sup> 42 U.S.C.A. § 9601(14) (West 2005 and Supp. 2010). The courts have held that the “petroleum exclusion” includes crude oil that contains substances that would otherwise be classified as “hazardous substances” under CERCLA if they are naturally occurring in or “indigenous” to the crude oil. See *Wilshire Westwood Assoc. v. Atlantic Richfield Corp.*, 881 F.2d 801, 810 (9th Cir. 1989). Under OPA ’90, however, the “petroleum exclusion” is lost once the petroleum substance enters the waters of the United States. 33 U.S.C.A. § 2701(23) (West 2010).

<sup>176</sup> 42 U.S.C.A. § 9601(14) (West 2005 and Supp. 2010).

<sup>177</sup> 42 U.S.C.A. § 6921, *et seq.* (West 2005 and Supp. 2010).

<sup>178</sup> *Id.* at § 6921(b)(2).

3. Owners and Operators. The foregoing exclusions do not, of course, provide a perfect environmental liability shield for production payment holders. Assuming that a release of a regulated hazardous substance occurs on an oil and gas lease, a production payment holder's environmental liability exposure under CERCLA will depend principally on whether the production payment holder is characterized as the "owner" or "operator" of the affected facility.

(a) Owner Liability. Under CERCLA, both current owners of the facility where the hazardous substance is located, as well as prior owners of the facility at the time when disposal of the hazardous substances occurred, are subject to liability.<sup>179</sup> CERCLA defines an "owner" as any person who owns a facility.<sup>180</sup> At the time of CERCLA's passage, Congress indicated that the term "owner" was intended to include not only persons holding legal title to a facility, but also "those who, in the absence of holding title, possess some equivalent evidence of ownership."<sup>181</sup> Expressly excluded from the definition of "owner" are persons "who, without participating in the management of a vessel or facility, hold indicia of ownership primarily to protect his security interest in the vessel or facility."<sup>182</sup> This is the so-called "secured lender exclusion."

The courts have interpreted CERCLA's definition of owner very broadly. As might be expected, in cases involving the disposal of hazardous waste by a lessee under a commercial real estate lease, the owner of fee simple title to the burdened land is liable as an owner under CERCLA.<sup>183</sup> Legal title may not be dispositive of the question of ownership, however. In a case in which a corporation purchased

<sup>179</sup> Id. at §§ 9607(a)(1) and (2).

<sup>180</sup> Id. at § 9601(20).

<sup>181</sup> H. Rep. No. 172, 96<sup>th</sup> Cong., 2d Sess. (1980).

<sup>182</sup> 42 U.S.C.A. § 9601(20)(A) (West, 2010). In *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990), *reh'g denied en banc*, 911 F.2d 742 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991), the court strictly interpreted the "secured lender exclusion" and held a secured creditor liable for environmental clean-up costs because of the extent of its active participation in the management decisions of the borrower, which was the owner and operator of the contaminated facility.

<sup>183</sup> *E.g.*, *United States v. South Carolina Recycling Disposal, Inc.*, 563 F. Supp. 984, 993, 1003 (D.S.C. 1984), *aff'd in part, vacated in part*, 858 F.2d 160 (4th Cir. 1989), *cert. denied*, 490 U.S. 1106 (1989).

a hazardous waste site from a trustee in bankruptcy and immediately conveyed the property to three individuals, the court refused to grant a motion for summary judgment dismissing the corporation from the suit, stating that "[p]ossession of title, or lack thereof, is not necessarily dispositive with respect to questions of ownership or control."<sup>184</sup> Indeed, the Environmental Protection Agency has taken the position that the language of CERCLA provides "an independent statutory basis for imposing liability (notwithstanding the general principles of corporate law)" against parent corporations, directors, and shareholders of corporations subject to potential environmental liabilities.<sup>185</sup>

(b) Operator Liability. Under CERCLA, the "operator" of a facility is also subject to potential liability.<sup>186</sup> A person need not be an owner of a facility in order to incur liability under CERCLA if it is an operator. The key to "operator" status under CERCLA is the ability to exercise operational responsibility or control over the facility creating the environmental risk. Thus, for example, in *Edward Hines Lumber Co. v. Vulcan Materials Co.*,<sup>187</sup> the court concluded that the supplier of chemicals to a contaminated facility – a person who designed and built the facility and had the right to inspect the manufactured product from the facility – was not the operator of the facility within the meaning of CERCLA, because the supplier lacked the day-to-day control over facility operations.<sup>188</sup>

4. Potential Liability of Production Payments. As previously discussed, under Texas law, a production payment is an incorporeal, non-possessory interest in real property, in most cases carved out of the oil and gas leasehold estate. As such, the production payment holder: (a) acquires no present interest in the oil and gas leasehold estate burdened by the production payment, the surface estate in the land covered by the burdened lease, or any of the personal property, equipment, or facilities located thereon; (b) incurs no obligation to pay any costs or expenses

<sup>184</sup> *United States v. Carolawn Co.*, 21 Env't Rep. Cas. (BNA) 2124, 2128-29 (D.S.C. June 15, 1984).

<sup>185</sup> See Cope, *supra* note 166, at 1-24, 1-25.

<sup>186</sup> 42 U.S.C.A. § 9607(a) (West 2005 and Supp. 2010).

<sup>187</sup> 861 F.2d 155 (7th Cir. 1988).

<sup>188</sup> *Id.* at 157. See also *Nurad Inc. v. William E. Hooper and Sons Co.*, 966 F.2d 837, 842-43 (5th Cir. 1992) (actual exercise of control is not required; the unexercised right to control is sufficient).

associated with the exploration, development, and operation of, and production of hydrocarbons from, the burdened leases; and (c) acquires no present possessory right to drill wells or conduct other oil and gas operations on the burdened leases, or otherwise assume operational control of or responsibility for the burdened leases or the personal property, equipment, and facilities located thereon.<sup>189</sup> Under these circumstances, several commentators persuasively argue that the holder of a production payment should not be characterized as either an owner or an operator of a facility under CERCLA.<sup>190</sup>

On the other hand, as will be discussed later in this paper, most production payment documentation creates numerous obligations for the grantor of the production payment in respect of its operations on the burdened leases and gives the production payment holder significant rights to take control of operations on the burdened leases (including, in some cases, the right to foreclose a lien granted to secure the grantor's performance of such obligations) if the grantor defaults on its obligations under the production payment documents. Under these circumstances the production payment holder may well acquire sufficient operational responsibility and control over the burdened leases, or even ownership thereof, to be characterized as the owner and/or operator thereof under CERCLA.<sup>191</sup>

Some commentators suggest that, because production payments are often used as financing vehicles, the production payment holder may be entitled to take advantage of the secured lender exclusion from characterization as an owner under CERCLA.<sup>192</sup> Unless a production payment holder has foreclosed a lien against the grantor's interests in the burdened lease following the grantor's default on its obligations under the production payment documentation, however, this approach to avoidance of CERCLA liability is less than desirable for a production payment holder because it is unclear what effect the production payment holder's assertion of secured creditor status under CERCLA would have on the characterization of the production payment for

state law, federal income tax, and bankruptcy purposes.

On balance, until the courts speak on the issue of production payment holder liability under CERCLA, the greatest comfort for production payment holders in this regard comes from the "petroleum exclusion" under CERCLA and the "drilling waste exclusion" under CERCLA, which dramatically reduce the opportunities for environmental liability to arise under these statutes out of conventional, onshore oil and gas operations.

### III. DOCUMENTING THE PRODUCTION PAYMENT TRANSACTION

#### A. Structures and Documents

Depending on the objectives of the oil and gas producer selling a production payment (the "PP Grantor") and the requirements of the purchaser, transactions involving the carve-out of a production payment will involve a conveyance of the production payment by the PP Grantor either directly to the purchaser or to a special purpose entity formed to facilitate the financing of the purchase.

In the case of a production payment utilized to obtain vendor financing, the documentation will generally consist of (a) a new drilling or other service contract between the PP Grantor and the relevant contractor or service company that describes the services to be performed and the compensation to be paid therefor, including the portion of the compensation to be satisfied by the production payment, and (b) a conveyance by the PP Grantor directly to the contractor or service company of a dollar-denominated production payment in the amount agreed to by the parties.<sup>193</sup>

Dollar denominated production payments are also attractive financing vehicles for different types of investors – private equity funds, hedge funds, TEOs, and the like – and other non-traditional lending institutions who are willing to accept more risk in exchange for higher rates of return than are available to banks and other traditional lenders. The author has worked on DDPP transactions (a) pledged for the exploration or development of a single property (in most cases, to assist the PP Grantor in obtaining capital for further development of the burdened lease after the successful completion of the initial well) as to which tax treatment as a mortgage loan is not available under Section 636 of the Tax Code, and (B)

<sup>189</sup> See notes 4-14, *supra*, and accompanying text.

<sup>190</sup> See Cope, *supra* note 166, at 1-31, 1-41; Heintz, *supra* note 2, at 5-32 – 5-34; Glass, *supra* note 2, at 17-18; Strohl, *supra* note 2, at 16-34 – 16-37.

<sup>191</sup> See Gibson, *supra* note 2, at 23, 24; *Aufill, Environmental Liabilities of Landowners and Non-Operating Parties*, 20<sup>th</sup> OIL, GAS & MIN. L. INST., Paper 4 at 8 (Univ. of Texas School of Law, St. Bar of Texas OGML Section, March 25, 1994).

<sup>192</sup> See, e.g., Strohl, *supra* note 2, at 16-37, 16-38.

<sup>193</sup> This is the basic transaction structure described in *Terry Oilfield Supply Co. v. American Security Bank*, 195 B.R. 66 (S.D. Tex. 1996), and *Prince Bros. Drilling Co. v. Furhman Petroleum Corp.*, 150 S.W.2d 314 (Tex. Civ. App. – El Paso 1941, writ ref'd).

intended to monetize a group of developed leases on a “blanket” basis as to which mortgage loan tax treatment is available under Section 636 of the Tax Code.<sup>194</sup> In each of the several dollar-denominated production payment transactions on which the author has worked over the past two years, the investors purchasing the DDPPs have consistently elected not to employ a special purpose entity structure, preferring, instead, to syndicate their investments in the DDPPs by receiving direct conveyances of undivided interests therein.

Volumetric production payments are attractive to many of the same investors, as well as to companies engaged in the aggregation and marketing of, in particular, natural gas. VPPs may be utilized, for example, (a) to monetize a group of developed leases on a “blanket” basis, (b) to finance the acquisition of producing oil and gas properties (in this structure, the seller of the properties conveys the VPP to a wholly-owned subsidiary, and then conveys the now-burdened properties to the purchaser, “subject to” the production payment), and (c) to provide sources of gas supply, on a prepaid basis, to local distribution companies. All of such transactions would be entitled to mortgage loan tax treatment under Section 636 of the Tax Code. Since the development of the modern VPP began in the 1990s, these transactions have commonly employed a structure in which the producer conveys the VPP to a special purpose entity, usually a limited partnership or a grantor trust, which then either obtains conventional bank financing for the purchase price of the VPP or issues notes and beneficial interests, partnership interests, or another form of equity to the investor syndicate providing such financing.<sup>195</sup>

Regardless of whether a volumetric or dollar-denominated production payment is utilized, current practice for these transactions calls for three primary documents: (a) a purchase and sale agreement (the “PSA”); (b) a conveyance of the production payment (the “PP Conveyance”); and (c) a production and delivery agreement (the “P & D Agreement”). The rest of this paper will address selected issues related to the negotiation and drafting of these documents.

#### **B. Purchase and Sale Agreement**

In the author’s experience, the PSA is a relatively short, straightforward agreement executed concurrently with the execution of the PP Conveyance, pursuant to which the production

payment is actually granted. As such, the PSA will customarily contain:

- a provision providing for the conveyance of the production payment by the owner of the burdened lease (the “PP Grantor”) to the designated grantee (the “PP Grantee”) and the payment of the agreed upon purchase price for the sale of the production payment (the “Payment Amount”);
- representations and warranties relating to the PP Grantor and the burdened leases similar to those that would be found in a purchase and sale agreement for a sale of producing oil and gas properties, including representations and warranties concerning (i) the organization, existence, and good standing of the PP Grantor; (ii) the capacity and authority of the PP Grantor to enter into the transaction; (iii) the enforceability of the PSA, the PP Conveyance, the P & D Agreement, and the ancillary documents executed in connection with the transaction; (iv) non-contravention; (v) the absence of material litigation affecting the burdened leases or impairing the PP Grantor’s ability to consummate the transaction; (vi) applicable governmental and third-party consents, preferential rights to purchase, and other restrictions on transferability triggered by the transaction; (vii) title to the burdened leases; (viii) matters relating to the continued effectiveness of, and the absence of breaches with respect to, the burdened leases; (ix) the identification and continued effectiveness of, and the absence of breaches with respect to, material contracts to which the burdened leases are subject; (x) matters relating to the status of oil and gas marketing from the burdened leases, including the existence or absence of calls on production, gas imbalances, advance payment agreements, prepaid oil or gas sale agreements, take-or-pay makeup obligations, and similar matters; and (xi) the compliance by the lease owner with applicable laws, including laws relating to the environment;
- provisions identifying the documents in addition to the PP Conveyance executed in connection with the transaction, including officer’s certificates, board resolutions, certificates of existence and good standing, title opinions, other opinions of counsel, and similar matters;

<sup>194</sup> See Bradford and Mosley, *supra* note 2, at 22-8 – 22-11.

<sup>195</sup> See Murray I, *supra* note 2, at B-15 – B19.

- indemnities by the PP Grantor relating to the breach of any covenant, or the breach of or inaccuracy in any representation or warranty, of the PP Grantor contained in the PSA or the PP Conveyance; and
- provisions governing the transfer by the PP Grantor of the burdened leases, the effect of the transfer on the production payment, and, if applicable, the method of valuing the production payment upon its disposition in conjunction with such a sale or transfer of the burdened leases.<sup>196</sup>

### C. PP Conveyance

The most significant document executed in connection with a production payment transaction is, of course, the PP Conveyance, pursuant to which the production payment is actually created. In preparing a PP Conveyance, the following points, along with others too numerous to be addressed in this paper, should be kept in mind.

1. Grant. Although the concept of a “production payment” in the oil and gas context has a well-defined meaning under Texas law, it is clear from the discussion in Section II.B.3 of this paper<sup>197</sup> that this is not necessarily the case in other states. Since production payments have been widely characterized as a type of overriding royalty interest,<sup>198</sup> and because the law relating to overriding royalty interests is better developed in many states, it is not uncommon to see to a PP Conveyance styled as a “Conveyance of Term Overriding Royalty Interest.”<sup>199</sup>

a. Dollar Denominated Production Payments. In a dollar denominated production payment transaction, the PP Grantor typically conveys to the PP Grantee an undivided percentage (the “Production Payment Percentage”) of the hydrocarbons produced from the burdened lease until the PP Grantee has, from the proceeds from the sale of its share of the hydrocarbon production, either received a specified amount plus accrued interest (the “Production Payment Amount”) or achieved an agreed upon internal rate of return. Older DDPP transactions contemplated an amortization schedule against which the principle portion of the Production Payment Amount would be retired, thus requiring complex mechanisms to deal

with monthly shortfalls and excesses in payments received relative to the amortization schedule. Current practice, however, ordinarily does not utilize such an amortization schedule, making the grant of a DDPP a more straightforward concept. The following is a sample grant of a DDPP:

For and in consideration of the Payment Amount in hand paid to PP Grantor, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, PP Grantor hereby GRANTS, BARGAINS, SELLS, CONVEYS, ASSIGNS, SETS OVER, AND DELIVERS unto PP Grantee, effective as of the Effective Date and subject to the terms and conditions set forth hereinafter, a term overriding royalty interest (the “Production Payment”) equal to the Applicable Royalty Percentage of all Hydrocarbons (after deducting Lease Use Hydrocarbons) if, as, and when produced, saved, and sold from the Leases. The Production Payment shall remain in full force and effect from and after the Effective Date until the Termination Time.

In the foregoing example, the “Termination Time” refers to the point in time when the PP Grantee has received the Production Payment Amount in full or achieved the designated internal rate of return.

b. Volumetric Production Payments. Volumetric production payment transactions are more complex in certain respects than dollar denominated production payment transactions. In a VPP transaction, the PP Grantee is expected to receive, out of the Production Payment Percentage of the hydrocarbons produced from the burdened leases, scheduled volumes of hydrocarbons on a periodic basis (usually daily or monthly) (the “Scheduled Quantity”). Typically, the PP Conveyance contemplates ratable daily deliveries to facilitate matching physical hydrocarbon sales with expected sale volumes.<sup>200</sup> The Scheduled Quantity may also contemplate an economic factor that adjusts the Scheduled Quantity to compensate the PP Grantee for value, timing, and delivery location differences between actual deliveries of production payment hydrocarbons and those contemplated by the PP

<sup>196</sup> See, generally, Muñoz, *supra* note 2, at 231-32.

<sup>197</sup> See notes 71-93, *supra*, and accompanying text.

<sup>198</sup> See, e.g., Walker, *supra* note 15, at 269, quoted at note 61, *supra*.

<sup>199</sup> See Muñoz, *supra* note 2, at 229.

<sup>200</sup> See Muñoz, *supra* note 2, at 232-33; Bradford and Mosley, *supra* note 2, at 22-15.

Grantee at the outset of the transaction.<sup>201</sup> Shortfalls in actual hydrocarbon deliveries relative to the Scheduled Quantity are ordinarily resolved in kind during succeeding months.<sup>202</sup> The VPP terminates when the PP Grantee has received a specified volume of hydrocarbons, including all shortfall make-up volumes (the “Aggregate Quantity”).

This type of transaction leads to a more complex type of grant:

For and in consideration of the Payment Amount in hand paid to PP Grantor, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, PP Grantor hereby GRANTS, BARGAINS, SELLS, CONVEYS, ASSIGNS, SETS OVER, AND DELIVERS unto PP Grantee, effective as of the Effective Date, a term overriding royalty interest equal to the Production Payment Percentage of all Hydrocarbons (after deducting Lease Use Hydrocarbons) if, as, and when produced, saved, and sold from the Leases, but not to exceed on any Day the Scheduled Quantity for such Day to be delivered out of the first Hydrocarbons produced and saved from the Leases on such Day, together with all rights of PP Grantor to receive proceeds from the sale of Production Payment Hydrocarbons pursuant to contracts or otherwise and any and all other rights, title, interests, remedies, powers, and privileges appurtenant or incident thereto (the “Production Payment”). The Production Payment shall remain in full force and effect from the Effective Date until PP Grantee shall have received and realized, out of the Production Payment Hydrocarbons, the Aggregate Quantity.

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<sup>201</sup> See Muñoz, *supra* note 2, at 232.

<sup>202</sup> *Id.* In this regard, the Scheduled Quantity is ordinarily set at a volume of hydrocarbons less than the full Production Payment Percentage of all hydrocarbons produced from the burdened leases in order to provide to the PP Grantor the flexibility to make up shortfall volumes within the cap provided by the Production Payment Percentage. *Id.*; Bradford and Mosley, *supra* note 2, at 22-15.

2. Burdened Leases. As discussed above, production payments pledged for the exploration or development of a mineral property for purposes of Section 636 of the Tax Code may only burden the property to be developed with the funds received from the sale of the production payment.<sup>203</sup> Most other volumetric and dollar denominated production payments will burden multiple oil and gas leases located, many times, in several states. This approach can be beneficial to both the PP Grantor and the PP Grantee because it allows the positive cash flow from certain wells to offset negative cash flow from other wells in the package, thereby reducing the strain on the PP Grantor’s cash flow caused by the production payment and, at the same time, spreading the reserve risk and improving the likelihood of recovery of the full amount of the Production Payment by the PP Grantee.<sup>204</sup>

a. Transfers of Less Than All of the Burdened Leases. The creation of a production payment covering multiple leases obviously complicates subsequent transfers of the PP Grantor’s interest in all or a portion of the burdened leases.<sup>205</sup> For this reason, it is important for either the PSA or the PP Conveyance to provide a mechanism for allocating and valuing the portion of the production payment burdening the leases to be sold, so that the PP Grantee may be properly compensated if it sells all or a portion of its production payment in conjunction with the sale of the relevant burdened leases. For income tax purposes, such a partial sale will result in the apportionment of the production payment between its transferred and retained portions based on the relative fair market values of the respective interests.<sup>206</sup> If the transferee of the leases does not also purchase the portion of the production payment burdening such leases, the PSA or the PP Conveyance should provide for the partition of the production payment into two separate and distinct production payment, one of which burdens the leases sold to the transferee and the other of which burdens the leases retained by the PP Grantor.

b. “Alternate Source” Issues. The Treasury Regulations clearly provide that a production payment may cover more than one mineral property (as defined

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<sup>203</sup> See notes 210-13, *infra*, and accompanying text.

<sup>204</sup> See Dunlap I, *supra* note 2, at 13.

<sup>205</sup> See Sherrill, *supra* note 2, at 177-78.

<sup>206</sup> Treas Reg. § 1.636-1(c)(3).

in Section 614 of the Tax Code).<sup>207</sup> As a result, the owner of a production payment burdening multiple properties (a “blanket” production payment) will have an economic interest in such mineral properties (assuming satisfaction of all other elements of the “economic interest” test), and the fact that the production payment may be satisfied from multiple mineral properties does not cause the production payment to run afoul of the Alternate Source Rule.<sup>208</sup>

The trap for the unwary in this regard arises if the PP Grantee attempts to provide additional assurance of the satisfaction of the production payment burdening property A by requiring that any unpaid amounts at depletion of property A be added to a separate production payment on property B. In the case of such “cross-collateralized” production payments, the Internal Revenue Service and the courts have held that the Alternate Source Rule is breached because the satisfaction of the production payment burdening property A is collateralized by that burdening property B.<sup>209</sup>

As discussed previously,<sup>210</sup> production payments pledged for exploration or development are an exception to the rules permitting blanket production payments. Interestingly, the Treasury Regulations addressing the exploration or development exception actually provide that a production payment may be carved out for exploration or development of a “property (or properties).”<sup>211</sup> Notwithstanding the Regulations, the Internal Revenue Service, in a continuing attempt to narrow the application of G.C.M. 22,730, insists that the exploration or development exception does not apply to a production payment that burdens more than one property.<sup>212</sup> In

the Service’s view, the reference in the legislative history of Section 636(a) to treatment “under existing law” necessarily related to the pool of capital doctrine as described in G.C.M. 22,730. G.C.M. 22,730 provided that the transfer of a production payment in return for consideration pledged to exploration or development of *the burdened property* did not result in the realization of gain or loss by the transferor. As to the use of the phrase “property (or properties)” in the Regulations, the Service “explained” in G.C.M. 36,663 that at the time of G.C.M. 22,730, a single tract of land containing several mineral deposits could be considered a single property. Thus, the phrase “property (or properties)” was “intended only to recognize that the exploration or development exception includes production payments carved from a single tract of land containing several mineral deposits.”<sup>213</sup>

c. Extensions and Renewals. As a general matter, the owner of an oil and gas lease has no duty to the owner of a non-operating interest to maintain the burdened lease in force and effect and is ordinarily not subject to an action for damages if it fails to do so.<sup>214</sup> Indeed, although several Oklahoma cases have suggested that the owner of a lease has an implied duty of fair dealing and is barred from conduct intended to extinguish, or “wash out”, the non-operating interest while preserving its own interest,<sup>215</sup> the Texas courts have not recognized any such duty on the part of the lease owner.<sup>216</sup>

<sup>207</sup> Treas Reg. 1.636-3(a)(1).

<sup>208</sup> See G.C.M. 32478 (January 3, 1963); Leggett, *supra* note 102, at 16-23 – 16-24.

<sup>209</sup> E.g., *Lehigh Portland Cement Co. v. United States*, 433 F. Supp. 639 (D. Pa. 1977), *aff’d without opinion*, 78-2 U.S.T.C. ¶ 9498 (3<sup>rd</sup> Cir. 1978); G.C.M. 33584 (August 4, 1967); Priv. Ltr. Rul. 8614033 (January 6, 1986). See Leggett, *supra* note 102, at 16-24 – 16-25.

<sup>210</sup> See notes 124-25, *supra*, and accompanying text.

<sup>211</sup> Reg. § 1.636-1(b)(1).

<sup>212</sup> See P.L.R. 81-25-001 (December 24, 1980); P.L.R. 7401280010A (January 28, 1974) (the payment was “not selectively payable out of the oil and gas produced on each leasehold in proportion to the funds expended thereon.”). Cf. Rev. Rul. 77-176, 1977-1 C.B. 77 (interest received in specified drill site to which specified services were pledged protected under the pool of capital doctrine but receipt of interest in surrounding acreage was not).

<sup>213</sup> (March 26, 1976); Cf. T.D. 7261, 1973-1 C.B. 309 (“The proposed regulations had limited the application of the first exception to production payments carved out of a single mineral property ... [T]his limitation has been modified and the final regulations refer parenthetically to production payments which are created from more than one mineral property).

<sup>214</sup> See 2 WILLIAMS & MEYERS, *supra* note 4, §420.1 at 365.

<sup>215</sup> E.g., *Rees v. Briscoe*, 315 P.2d 758 (Okla. 1957) (court found that confidential relationship existed between a lease owner and an overriding royalty owner entitling the overriding royalty owner to receive its interest with respect to production from a new lease taken by the lessee after the original lease had terminated); *Oldland v. Gray*, 179 F.2d 408 (10<sup>th</sup> Cir. 1950) (same). See 2 WILLIAMS & MEYERS, *supra* note 4, §420.2 at 366.1, 366.2.

<sup>216</sup> E.g., *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798 (Tex. 1967) (court denied relief to owner of overriding royalty interest in lease containing “renewal and extension” clause after the original lease terminated due to lack of production and the lessee obtained production from a new lease taken more than one year after the original lease

For this reason, it is important that the PP Conveyance cover not only the burdened leases, but also any “extensions, renewals, and replacements” of the burdened leases. The Texas courts have narrowly construed the term “extensions and renewals.”<sup>217</sup> To maximize the applicability of the net profits interest, therefore, the PP Conveyance should expressly define “extensions, renewals, and replacements” to include wholly new leases taken upon or in an anticipation of the expiration or termination of a burdened lease, to the extent executed and delivered during the term of or within one year after the expiration or termination of the predecessor lease.<sup>218</sup>

3. Economic Life Test. To assure that the production payment satisfies the “expected economic life” test included in the definition of “production payment” under Section 636 of the Tax Code, the PP Conveyance should expressly provide that, in all events, the production payment will terminate upon the production of 90% of the hydrocarbon reserves underlying the burdened leases as of the effective date of the PP Conveyance.<sup>219</sup>

4. Non-Operating, Non-Cost Bearing Interest. The PP Conveyance should, of course, provide expressly that the production payment is a non-operating interest that bears no costs of exploration, development, operations, or production. Whether the production payment bears its share of “post-production costs” – gathering, treating, dehydration, separation, processing, or transportation costs, for example – or ad valorem and severance taxes will be a matter for negotiation by the parties. Further, the PP Conveyance should also expressly provide that the PP Grantee must look solely to the production payment hydrocarbons, or the proceeds from their sale, for satisfaction of the production payment.

5. Interest. There is no interest rate component or defined internal rate of return built into a volumetric production payment. The PP Grantee manages the interest rate risk, as well as the

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terminated; court refused to find a confidential relationship between the overriding royalty owner and the lessee). See *EOG Resources, Inc. v. Hanson Production Co.*, 94 S.W.3d 697 (Tex. App. -- San Antonio 2002, no pet.); *Sasser v. Dantex Oil & Gas, Inc.*, 906 S.W.2d 599 (Tex. App. -- San Antonio 1995, writ denied).

<sup>217</sup> *Id.*

<sup>218</sup> See Herbert and Taylor, *supra* note 2, at 14-30 – 14-32; Terrell, *supra* note 2, at 40-43.

<sup>219</sup> See notes 119-20, *supra*, and accompanying text.

commodity price risk, through appropriate hedging activities.<sup>220</sup> In a dollar denominated production payment, however, the Production Payment Amount includes an interest component, either in the form of interest accruing directly on the principle portion of the Production Payment Amount or the discount rate used to calculate the designated internal rate of return. The question then becomes, does this interest component create a usury issue for a DDPP transaction if the rate exceeds statutory usury limits?

A complete discussion of Texas usury laws is beyond the scope of the paper. It is sufficient to say that the basic elements for a finding of usury are (a) the existence of a loan of money, (b) an absolute obligation to repay the loan, and (c) “the extraction of greater compensation than allowed by law for the use of the money by the borrower.”<sup>221</sup> Because there is no personal obligation on the part of the PP Grantor to satisfy a production payment, production payments should not be held to be usurious transactions under this test. The seminal Texas case that reaches this result is *Pansy Oil Co. v. Federal Oil Co.*<sup>222</sup>, but several other cases discovered in our research in which the characterization of a production payment has been at issue have dealt with production payments that provide for the accrual of interest on the outstanding portion thereof.<sup>223</sup> In every such case, the courts have affirmed the characterization of the production payments as interests in real property.

6. Prepayment Rights; Takeout Letters. It is not uncommon for a PP Conveyance to provide for an express right on the part of the PP Grantor to prepay, or “call,” the production payment prior to its termination. In the limited Texas authority available on this point, the courts appear not to have found such prepayment options exercisable by the PP Grantor to be objectionable. The early case of *Prince Bros.*

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<sup>220</sup> See Munoz, *supra*, note 2, at 230.

<sup>221</sup> *Fears v. Mechanical & Industrial Technicians, Inc.*, 654 S.W.2d 524, 530 (Tex. Civ. App. – Tyler 1983, writ ref’d n.r.e.).

<sup>222</sup> 91 S.W.2d 453 (Tex. Civ. App. – Texarkana 1936, writ ref’d n.r.e.).

<sup>223</sup> *E.g.*, *Standard Oil Company of Texas v. Marshall*, 265 F.2d 46 (5th Cir. 1959), *cert. denied*, 361 U.S. 915, 80 S.Ct. 259 (1959); *Prince Bros. Drilling Co. v. Fuhrman Petroleum Corp.*, 150 S.W.2d 314 (Tex. Civ. App. - El Paso 1941, writ ref’d). See French, *Tax Problems of Production Payment Owners*, 20<sup>TH</sup> INST. ON OIL & GAS LAW & TAX. 301, 302 (Sw. Legal Fdn 1969); *Strohl, supra* note 2, at 16-40 – 16-41.

*Drilling Co. v. Fuhrman Petroleum Corp.*,<sup>224</sup> dealt with a production payment conveyance that appears to have given the payor the option to terminate the production payment in question at any time prior to its satisfaction by paying to the payee in cash the amount of the production payment then outstanding.<sup>225</sup> Although the court of civil appeals did not expressly address this provision in its opinion, the inclusion in the production payment conveyance of such a provision appears to have caused the court no difficulty in concluding that the production payment constituted a taxable interest in land in the hands of the payee thereof, rather than a mortgage.

For federal income tax purposes, however, there is authority that such a prepayment right constitutes a breach of the Alternate Source Rule, with the result that the production payment would not satisfy the definitional requirements of Section 636 of the Tax Code.<sup>226</sup>

A different result would likely result under state law, however, if the PP Grantor were required to prepay the production payment, either under a provision of the PP Conveyance or a so-called “takeout letter.” In *Able Finance Co. v. Whittaker*,<sup>227</sup> H assigned an oil and gas lease to W, reserving a hydrocarbon-type production payment. Concurrently with the execution of that assignment, H assigned the production payment to A, subject to a “take-out letter” from W in which W agreed to furnish to A, at A’s request, “a purchaser who will purchase for cash the unpaid balance due on said production payment. . . if said production payment has not been satisfied in full on or before twenty four (24) months from and after the date hereof.”<sup>228</sup> At the end of such two-year period, A demanded that W comply with its agreement to find a purchaser, but W refused to do so.

A originally filed suit against W seeking specific performance of the take-out letter and the foreclosure of an implied lien against W’s interest in the lease allegedly created by the take-out letter. In an appeal from a trial court order transferring the venue of the case from the county in which the land covered by the lease was located to another county, the San Antonio

Court of Civil Appeals held that the take-out letter created no such lien and that the change of venue was therefore properly granted.<sup>229</sup> In so holding, the court held that the assignment from H to A vested A with title to a “production payment, but not a lien.”<sup>230</sup>

Thereafter, A amended its pleadings and sought to recover damages only for a breach of contract. The trial court entered judgment in favor of W and denied A’s motion for summary judgment. The Tyler Court of Civil Appeals reversed the trial court judgment, however, holding that the transaction evidenced a valid contract on the part of W to find a purchaser for the production payment after demand, and that upon his failure to find such a purchaser, he breached his contract and was liable to A for the balance then due on the production payment.<sup>231</sup> The court held that the decision of the San Antonio Court of Civil Appeals in the venue appeal had no controlling effect on the case at bar because of the plaintiff’s amendment of its pleadings following the venue appeal.<sup>232</sup>

The view of Professors Williams and Meyers concerning the consequence of the *Whittaker* case is unequivocal:

As thus construed, the take-out letter introduced an absolute obligation on the part [W] to make the payment whether or not the production sufficed for the purpose; under such circumstances the transaction should be viewed as a mortgage.<sup>233</sup>

This analysis appears correct in light of the *Whittaker* court’s apparent elevation of the take-out letter in question to the status of a personal guaranty of payment on the part of W. Our research has discovered no subsequent cases, however, in which the Texas courts have expressly dealt with the characterization of a production payment subject to a take-out letter. Such a take-out letter is also likely to constitute a breach of the Alternate Source Rule for federal income tax purposes.<sup>234</sup>

<sup>224</sup> 150 S.W.2d 314 (Tex. Civ. App. - El Paso 1941, writ ref’d).

<sup>225</sup> *Id.* at 315.

<sup>226</sup> See Priv. Ltr. Rul. 93-05-014 (November 10, 1992); Priv. Ltr. Rul. 93-16-033 (January 26, 1993); Priv. Ltr. Rul. 94-14-021.

<sup>227</sup> 388 S.W.2d 437 (Tex. Civ. App. - Tyler 1965, writ dism’d by agr.).

<sup>228</sup> *Id.* at 439.

<sup>229</sup> *Able Finance Co. v. Whittaker*, 360 S.W.2d 892, 893 (Tex. Civ. App - San Antonio 1962, no writ).

<sup>230</sup> *Id.* at 893, citing the *Sheppard* case as controlling authority.

<sup>231</sup> 388 S.W.2d at 439

<sup>232</sup> *Id.* at 440.

<sup>233</sup> 2 WILLIAMS & MEYERS, *supra* note 4, §423.10 at 412.

<sup>234</sup> See, e.g., *Estate of Donnell v. Comm’r*, 417 F.2d 106 (5<sup>th</sup> Cir. 1969); Rev. Rul. 69-262, 1969-1 C.B. 166.

#### D. P & D Agreement

The use of a P & D Agreement evolved as part of the development of the transaction structure for volumetric production payments during the 1990s. Historically, the covenants by the PP Grantor associated with a production payment, and the rights and remedies of the PP Grantee with respect thereto, were contained in the PP Conveyance itself. The creation of the modern VPP introduced the need for more complex covenants regarding the handling and physical delivery of the hydrocarbons subject to the VPP, however, and the segregation into a separate agreement of these new covenants, as well as the traditional covenants, rights, and remedies of the PP Grantor and PP Grantee, became the common practice in both volumetric and dollar denominated production payment transactions.

As such, the P & D Agreement customarily contains:

- in VPP transactions, detailed provisions relating to the marketing of the production payment hydrocarbons (whether such hydrocarbons are sold by the PP Grantor on the PP Grantee's behalf, or are taken in kind and marketed by the PP Grantee), scheduling the hydrocarbons for delivery, and gathering, transportation, and hydrocarbon measurement and quality issues;
- particularly with respect to production payments pledged for exploration or development, covenants regarding the PP Grantor's obligations to drill wells and otherwise develop the burdened lease(s);
- covenants by the PP Grantor to (a) maintain, develop, protect against drainage, and operate continuously the burdened leases in a good and workmanlike manner as a prudent operator and in accordance with applicable laws, including environmental laws; (b) pay delay rentals and royalties when due; (c) maintain all surface facilities and equipment in good working order; (d) keep the burdened leases free of liens and encumbrances; and (e) carry adequate insurance with respect to the burdened leases;
- covenants and procedures regarding the abandonment of wells and the surrender by the PP Grantor of one or more burdened leases;
- covenants by the PP Grantor to provide specified periodic reserve, production, sales, cost, and other information and data relating to operations on the burdened leases; and

- the rights and remedies available to the PP Grantee in the event of the breach or failure by the PP Grantor to perform its covenants under the PP Conveyance or the P & D Agreement.<sup>235</sup>

In negotiating the P & D Agreement, the following points should be kept in mind:

1. Bankruptcy Treatment. If the covenants, rights, and remedies contained in the P & D Agreement were included in the PP Conveyance, there is little doubt that such covenants, rights, and remedies would not be disturbed by the bankruptcy of the PP Grantor since they would be a part of the document creating a property right that would not be a part of the debtor's estate in bankruptcy under Section 541(b)(4)(B) of the Bankruptcy Code. Since the use of a P & D Agreement segregates these covenants, rights, and remedies from the PP Conveyance, however, a threshold question is whether the P & D Agreement would be treated as an executory contract in the event of the PP Grantor's bankruptcy.

Under Section 365 of the Bankruptcy Code, a trustee or the debtor in possession in bankruptcy may assume or reject any executory contract or unexpired lease.<sup>236</sup> The Bankruptcy Code does not define the term "executory contract". However, the legislative history describes an executory contract as one "on which performance remained due to some extent on both sides."<sup>237</sup>

Under Section 365 of the Bankruptcy Code, the trustee in bankruptcy may not assume any executory contract or unexpired lease as to which the debtor is in default unless the trustee cures the default, compensates the other party for its pecuniary loss due to the breach, and provides adequate assurance of future performance under the contract.<sup>238</sup> When an executory contract has not been previously assumed, rejection constitutes a breach of the contract immediately before the date of the filing of the bankruptcy petition. The purpose of this rule is to make clear that, under the doctrine of relation back, the other party to a contract that has not been assumed is simply a general unsecured creditor.<sup>239</sup> The effect of the breach is to permit the creditor to seek

<sup>235</sup> See Munoz, *supra* note 2, at 233-34.

<sup>236</sup> 11 U.S.C.A. §365(a) (West 2010).

<sup>237</sup> S.REP. No. 989, 95<sup>th</sup> Cong., 2d Sess. (1978); 58, U.S. CODE CONG. & ADMIN. NEWS (1978) 5787, 5844

<sup>238</sup> 11 U.S.C.A. §365(b) (West 2010).

<sup>239</sup> 3 COLLIER ON BANKRUPTCY §365.09[1] (15<sup>th</sup> ed. 2007).

allowance of any claim for damages under Section 502 of the Bankruptcy Code.<sup>240</sup>

It is also important to note what rejection does not do. It is well established that rejection does not affect the substantive rights of the parties under the rejected contract, and does not result in an abrogation of real, personal, or intangible rights and interests enforceable under state law.<sup>241</sup> Rather, when ownership interests are conveyed to and vested in the non-debtor prior to rejection, the rejection of the underlying contract, if permitted at all, does not divest the non-debtor of the conveyed interests because rejection is not the equivalent of contract rescission.<sup>242</sup> As stated by one commentator:

The contract is not rescinded by rejection, the estate simply does not become obligated on it. Thus, the estate's rights in the underlying asset – the copyright, trade secret, patent, equipment, or other property – still are no greater than the debtor had to give, absent a true avoiding power attack. The estate acquires only the rights to that asset that would be acquired by any other ordinary transferee who declined to assume the debtor's contract obligation.<sup>243</sup>

Consistent with the legislative history of Section 365 quoted above, the term “executory contract” has been defined by the great majority of courts, including courts in the Fifth Circuit, to mean a contract “under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance

<sup>240</sup> 11 U.S.C.A. §502 (West 2010). See COLLIER ON BANKRUPTCY §365.09[1] (15<sup>th</sup> ed. 2007).

<sup>241</sup> E.g., *Matter of Austin Development Co.*, 19 F.3d 1077, 1082-83 (5th Cir. 1994), cert. denied, 115 S.Ct. 201 (1994); *Cohen v. Drexel Burnham Lambert Group, Inc.* (In re Drexel Burnham Lambert Group, Inc.), 138 B.R. 687, 709 (Bankr. S.D. N.Y. 1992); *In re Walnut Associates*, 145 B.R. 489 (Bankr.E.D.Pa. 1992); *Seymor v. Hamlin* (In re Seymor), 144 B.R. 524, 530 (Bankr.D.Kan. 1992). See 3 COLLIER ON BANKRUPTCY §365.09[1] (15<sup>th</sup> ed. 2007).

<sup>242</sup> *Bond Street Assoc. v. TJX Cos. (In re Ames Dept. Stores, Inc.)*, 148 B.R. 756 (Bankr. S.D.N.Y. 1993); *In re Independent American Real Estate, Inc.*, 146 B.R. 546 (Bankr. N.D.Tex. 1992).

<sup>243</sup> Andrew, “*Executory Contracts in Bankruptcy: Understanding ‘Rejection,’*” 59 U. COLO. L. REV. 845, 851 (1988).

of the other.”<sup>244</sup> Because this definition was originally formulated by the noted bankruptcy expert, Professor Vern Countryman, it is known as the “Countryman Definition”.<sup>245</sup>

Under a properly drafted P & D Agreement, all of the covenants and obligations to be performed thereunder are owed by the PP Grantor. Although the PP Grantee has a number of rights that it may exercise, the exercise of those rights is optional on the part of the PP Grantee. In the absence of unperformed, reciprocal obligations owed to each other by the PP Grantor and the PP Grantee, a necessary element of the Countryman Definition of executory contract is missing.

It should be noted that our research has not discovered any cases that address this issue. Assuming the bankruptcy courts' continued application of the Countryman Definition, however, it is reasonable to expect that a properly drafted P & D Agreement should not be treated as an executory contract under Section 365 of the Bankruptcy Code.

2. Operational Covenants. As discussed above, the P&D Agreement ordinarily contains a number of covenants by the PP Grantor relating to operations on the burdened leases, including maintenance of continuous operations, prevention of drainage, marketing of the production payment hydrocarbons, development of the burdened leases, and similar matters. The question becomes whether the presence

<sup>244</sup> E.g., *In re Murexco Petroleum, Inc.*, 15 F. 3d 60, 62 (5th Cir. 1994); *In re CVA General Contractors, Inc.*, 267 B.R. 773 (W.D.Tex. 2001).

<sup>245</sup> See Countryman, *Executory Contracts in Bankruptcy (Part 1)*, 57 MINN. L. REV. 439, 460 (1973). Although the Countryman Definition represents the clear majority approach to defining executory contracts for purposes of Section 365, there is an emerging alternative theory of executory contracts that should be mentioned. This theory, generally referred to as the “Functional Approach”, evolved from a series of articles written by two law professors, Michael Andrew and Jay Westbrook. See Andrew, *Executory Contracts in Bankruptcy: Understanding ‘Rejection,’* 59 U. COLO. L. REV. 845 (1988); Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991); Westbrook, “*A Functional Analysis of Executory Contracts*”, 74 MINN. L. REV. 227 (1989). Under the Functional Approach, an executory contract is one in which the debtor has unperformed obligations that the trustee in bankruptcy may elect to perform or breach, depending on which will result in the best value for the estate. 3 COLLIER ON BANKRUPTCY §365.02 at 365-19 (15<sup>th</sup> ed. 2007).

of these covenants alters in any way the legal characterization of the production payment.

Under the laws of Texas and other producing states, the owner of an overriding royalty, production payment, net profits interest, or other non-operating interest is generally not entitled to the benefit of the covenants, either expressed or implied, of the underlying oil and gas lease, in the absence of an expressed provision to the contrary in the creating instrument.<sup>246</sup> In some circumstances, however, the courts may imply certain covenants in connection with a grant or a reservation of a non-operating interest to protect the non-operating interest owner that are similar to those contained or implied in an oil and gas lease for the protection of the lessor. The Texas Supreme Court articulated the rationale underlying these implied covenants as follows:

An implied covenant must rest entirely on the presumed intention of the parties as gathered from the terms as actually expressed in the written instrument itself, and it must appear that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore omitted to do so, or it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument. It is not enough to say that an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly. It must arise from the presumed intention of the parties as gathered from the instrument as a whole. [citations omitted] However, covenants will be implied in fact when necessary to give effect to the actual intention of the parties as

reflected by the contract or conveyance as construed in its entirety in the light of the circumstances under which it was made and the purposes sought to be accomplished thereby.<sup>247</sup>

Under this rationale, some courts have implied certain covenants to protect the owner of a non-operating interest when the reasons for implying covenants by an oil and gas lessee to protect the interests of its lessor are also applicable to the relationship of the non-operating interest owner and the working interest owner. These reasons have generally been found to exist when substantial consideration is paid for the non-operating interest or a reserved non-operating interest is the only consideration received by the assignor for an assignment of an oil and gas lease.<sup>248</sup> Thus, for example, in *Cole Petroleum Co. v. United States Gas & Oil Co.*<sup>249</sup>, the Texas Supreme Court, in interpreting an assignment of an oil and gas lease in which the assignor reserved an overriding royalty interest as the consideration for the assignment and the assignee undertook a general obligation to "develop said lease to a normal stage of production,"<sup>250</sup> held that the quoted development obligation gave rise to an implied covenant to market the assignor/overriding royalty owner's share of production from the lease with reasonable diligence so as to secure to the assignor the consideration (the reserved overriding royalty interest) recited in the assignment.<sup>251</sup>

The implied covenant most consistently recognized by the Texas courts as arising out of the working interest owner – non-operating interest owner relationship is the implied covenant to prevent drainage.<sup>252</sup> Thus, in *Bolton v. Coats*,<sup>253</sup> the assignor

<sup>247</sup> *Danciger Oil & Refining Co. of Texas v. Powell*, 137 Tex. 484, 154 S.W.2d 632, 635 (1941).

<sup>248</sup> See 2 Williams & Meyers, *supra* note 4, §420.1 at 360-61.

<sup>249</sup> 121 Tex. 59, 41 S.W.2d 414 (1931).

<sup>250</sup> 41 S.W.2d at 415.

<sup>251</sup> *Id.* at 416. Similar results were reached by the Colorado courts in *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001) ("The implied covenant to market extends to both the royalty interest and the overriding royalty interest owners since the rationale for application of the covenant applies equally to both interests."); and *Gorman v. Conoco Inc.*, 886 P.2d 652 (Colo. 1994).

<sup>252</sup> *E.g. Phillips Petroleum Co. v. Taylor*, 116 F.2d 994, 996 (5<sup>th</sup> Cir. 1941), *cert. denied*, 313 U.S. 565 (1941); *Bolton v. Coats*, 533 S.W.2d 914, 916 (Tex. 1975); *Wes-*

<sup>246</sup> See, e.g. *Ebberts v. Carpenter Production Co.*, 256 S.W.2d 601 (Tex. Civ. App. - Beaumont 1953, writ ref'd n.r.e.). Courts in several other states have taken the same position. See, e.g., *XAE Corp. v. SMR Property Management Co.*, 968 P.2d 1201 (Okla. 1998); *Kyle v. Amerada Petroleum Corp.*, 118 Okla. 176, 247 P. 681 (1925); *Campbell v. Nako Corp.*, 198 Kan. 421, 429, 424 P.2d 586, 592 (1967); *Continental Potash, Inc. v. Freeport-McMoran, Inc.*, 115 N.M. 690, 858 P.2d 66 (1993), *cert. denied*, 510 U.S. 1116 (1994).

of certain oil and gas leases, who reserved an overriding royalty interest in production from the assigned leases, brought suit against the assignee to recover for overriding royalty payments on oil actually produced from the assigned leases and damages for the assignee's alleged failure to protect the leased premises against drainage. The Texas Supreme Court reversed the judgments of the district court and the court of appeals and held that the assignor's actions did not constitute an impermissible collateral attack on a Railroad Commission order classifying the well located on the leased premises as a gas well.<sup>254</sup> In so holding, the court stated:

Unless the assignment provides to the contrary, the assignee of an oil and gas lease impliedly covenants to protect the premises against drainage when the assignor reserves an overriding royalty. The assignor is entitled to the benefit of the implied covenant under his assignments if his allegations are found to be true concerning drainage....<sup>255</sup>

Several courts in states other than Texas have reached the same result.<sup>256</sup>

In many other cases, however, no such protective covenants have been implied. Thus, in the absence of a contractual expression of intent, the Texas courts have not recognized an implied obligation by the working interest owner in favor of the non-operating interest owner to drill or otherwise develop the leased premises for oil or gas. The leading case on this subject is *Danciger Oil & Refining Co. of Texas v. Powell*.<sup>257</sup> In that case, the appellees granted to the

appellants undivided fee mineral interests in two tracts of land in exchange for a cash consideration and the reservation of an overriding royalty interest. The appellees/overriding royalty owners subsequently filed suit against the appellants for damages based on the appellants' alleged failure to develop the subject lands for oil and gas after the discovery thereof. The Texas Supreme Court rejected the appellees' claim and held that the mineral conveyance at issue did not give rise to an implied covenant to develop.<sup>258</sup> After stating the above quoted rationale for the implication of covenants in a contract<sup>259</sup>, the court cited the following factors in support of its holding: (a) the document at issue was a mineral conveyance, not an oil and gas lease, so that its primary purpose was not to cause the subject lands promptly to be explored and thoroughly developed for oil and gas; (b) the appellees/overriding royalty owners had received a substantial cash consideration; (c) the conveyance contained no specific drilling or development obligations other than to protect the subject lands from drainage; and (d) any future oil and gas operations were to be "subject only to the limitations and covenants hereinafter set forth."<sup>260</sup>

In like manner, the Texas courts have not recognized an implied obligation by a working interest owner in favor of a non-operating interest owner (i) to continue to operate a well located on the leased premises at a loss<sup>261</sup>; (b) to renew or extend an oil and gas lease<sup>262</sup>; or (c) to maintain an oil and gas lease in force by the payment of rentals.<sup>263</sup>

<sup>258</sup> 154 S.W.2d at 632.

<sup>259</sup> See text accompanying note 247, *supra*.

<sup>260</sup> *Id.* The Texas Supreme Court had earlier reached a similar result in *Freeport Sulphur Co. v. American Sulphur Royalty Co.*, 117 Tex. 439, 6 S.W.2d 1039 (1928). Courts in several other states have reached similar results. *E.g.*, *Matthews v. Ramsey-Lloyd Oil Co.*, 121 Kan. 75, 245 P. 1064 (1926); *Phoenix Oil Co. v. Mid-Continent Petroleum Corp.*, 177 Okla. 530, 60 P.2d 1054 (1936). *Contra*, *ANR Western Coal Development Co. v. Basin Electric Power Cooperative*, 276 F.3d 957, 966 (8<sup>th</sup> Cir. 2002) (applying North Dakota law) (implied covenant of reasonable development enforceable by owner of overriding royalty interest in coal).

<sup>261</sup> See *Tunstill v. Gulf Production Co.*, 79 S.W.2d 657 (Tex. Civ. App. - Fort Worth 1934, writ ref'd).

<sup>262</sup> Under Texas law, a non-operating interest burdening an oil and gas leasehold terminates upon (i) the expiration of the underlying lease in accordance with its terms, *Sims Oil Co. v. Colquitt*, 2 S.W.2d 421, 422 (Tex. Comm'n App. 1928, jdgmt adopted); *Greenwood & Tyrrell v. Helm*, 264 S.W. 221, 223 (Tex. Civ. App. - San Antonio 1924, writ ref'd); or (ii) the surrender of the lease by the

*Tex Land Co. v. Simmons*, 566 S.W.2d 719, 721 (Tex. Civ. App. - Eastland 1978, writ ref'd n.r.e.).

<sup>253</sup> 533 S.W.2d 914 (Tex. 1975).

<sup>254</sup> *Id.* at 916.

<sup>255</sup> *Id.* at 917.

<sup>256</sup> *E.g.* *Cook v. El Paso Natural Gas Co.*, 560 F.2d 978 (10<sup>th</sup> Cir. 1977) (applying New Mexico law); *Continental Potash, Inc. v. Freeport-McMoran, Inc.*, 115 N.M. 690, 858 P.2d 66 (1993), *cert. denied*, 510 U.S. 1116 (1994); *Tidelands Royalty "B" Corp. v. Gulf Oil Corp.*, 611 F. Supp. 795, 802 (N. D. Tex. 1985) (applying Louisiana law). *Contra*, *Kyle v. Amerada Petroleum Corp.*, 118 Okla. 176, 247 P. 681 (1925) (the Oklahoma Supreme Court refused to imply a covenant by the assignee to protect the assignor's retained overriding royalty interest from drainage even when the drainage was caused by the assignee's operations on adjacent premises).

<sup>257</sup> 137 Tex. 484, 154 S.W.2d 632 (1941).

Based upon the foregoing, it is clear that the owner of a non-operating interest may not look to the judicial implication of covenants against the working interest owner as a reliable method of protecting such party's interest. This view is expressed by Professors Williams and Meyers as follows:

Our discussion to this point has indicated that the owner of non-operating share of the working interest may be at the mercy of the owner of the operating rights unless by contract he has been guaranteed certain protection. The obligations of the parties *inter se* should be spelled out in the instrument creating the non-operating interest. The burden and benefit of the duties imposed in such an instrument will run with the land in law and in equity.<sup>264</sup>

As a result, covenants of the type described above in connection with the overview of the P&D Agreement<sup>265</sup> are common in connection with the conveyances of non-operating interests<sup>266</sup>, and, when included in a conveyance of a production payment, have no effect upon the characterization, for state law purposes, of the interest conveyed as an interest in real property.<sup>267</sup>

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lessee, *Tunstill v. Gulf Production Co.*, 79 S.W.2d 657, 658 (Tex. Civ. App. - Fort Worth 1934, writ ref'd). Since no fiduciary relationship exists between a working interest owner and the owner of a non-operating interest, *see Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804-5 (Tex. 1967), the Texas courts have held that non-operating interests will not burden a new lease taken by the working interest owner after the termination of the lease originally burdened by the non-operating interest, provided that the termination of the burdened lease was not due to fraud or the breach of the working interest owner's duty of good faith to the Non-Operating Interest owner. *Thomas v. Warner-Quinlan Co.*, 65 S.W.2d 321, 324-25 (Tex. Civ. App. - Eastland 1933, writ ref'd); *Montgomery v. Phillips Petroleum Co.*, 49 S.W.2d 967, 973 (Tex. Civ. App. - Amarillo 1932, writ ref'd).

<sup>263</sup> *Sims Oil Co. v. Colquitt*, 2 S.W.2d 421, 422 (Tex. Comm'n App. 1928, jdgmt adopted); *Tunstill v. Gulf Production Co.*, 79 S.W.2d 657, 658 (Tex. Civ. App. - Fort Worth 1934, writ ref'd).

<sup>264</sup> 2 WILLIAMS & MEYERS, *supra* note 4, §428 at 468.

<sup>265</sup> *See* note 265, *supra*, and accompanying text.

<sup>266</sup> *See* 2 WILLIAMS & MEYERS, *supra* note 4, §428.8 at 483-89.

<sup>267</sup> *See Felber v. Sklar Oil Corp.*, 235 S.W.2d 481, 482-83 (Tex. Civ. App. - Texarkana 1950, writ ref'd) (production payment created pursuant to instrument

PP Grantees should be aware, however, that to the extent that these types of operations-related covenants, whether in appearance or in fact, increase the PP Grantee's level of operational responsibility and control over the burdened leases, such control may affect the PP Grantee's bankruptcy and environmental risks. Recall that, for a production payment to fall within the ambit of Section 541(b)(4)(B) of the Bankruptcy Code, the production payment must be conveyed to "an entity that does not participate in the operation of the" burdened lease.<sup>268</sup> If the PP Grantee assumes too high a level of operational control over the burdened lease in the P&D Agreement, the production payment may not satisfy the requirements of Section 541(b)(4)(B). In that event, the consequences to the PP Grantee of the PP Grantor's bankruptcy would presumably be determined by reference to pre-BRA '94 bankruptcy law.<sup>269</sup>

Similarly, recall that, in our analysis of the PP Grantee's potential exposure under CERCLA, the characterization of a person as an "operator" of a contaminated facility was determined in large part by whether the person is able to exercise operational responsibility and control over the facility.<sup>270</sup> Indeed, at least one case has held that the actual exercise of control is not required, and that the unexercised right to control is sufficient.<sup>271</sup> Thus, if a PP Grantee assumes too high a level of operational responsibility and control over the burdened lease in the P&D Agreement, its risk of characterization as an "operator" of a facility under CERCLA, as well as other environmental statutes, increases.

To date, the courts have not spoken on either of these issues, but PP Grantees should nevertheless be aware of the risks.

3. Remedies of PP Grantee. Finally, the P&D Agreement ordinarily contains provisions stating that if the PP Grantor breaches any of the covenants or agreements contained in the PP Conveyance or the

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containing covenants by the payor to develop the leased premises, preserve the lease, pay all operating expenses, and keep the leasehold estate free from mechanics and materialmens liens, held to constitute an interest in real property subject to gross production tax in the hands of the owner thereof).

<sup>268</sup> 11 U.S.C.A. §541 (b)(4)(B)(i) (West 2010).

<sup>269</sup> *See* notes 129-150, *supra*, and accompanying text.

<sup>270</sup> *See* notes 186-88, *supra*, and accompanying text.

<sup>271</sup> *Nurad Inc. v. William E. Hooper and Sons Co.*, 966 F.2<sup>nd</sup> 837, 842 (5<sup>th</sup> Cir. 1992).

P&D Agreement and fails to remedy such breach within a specified cure period after notice, or breaches any of its representations or warranties thereunder, the PP Grantee, in addition to its right to recover damages and other legal remedies, is authorized, *inter alia*, to:

- perform or cause to be performed the breached covenant, including the right to pay any unpaid costs and expenses owed by the PP Grantor;
- succeed to the PP Grantor's rights with respect to the possession, operation, and development of the burdened leases;
- if the PP Grantee is not taking the production payment hydrocarbons in kind, notify production purchasers, if not previously notified, to disburse directly to the PP Grantee the proceeds from the sale of the production payment hydrocarbons;
- succeed to all of the PP Grantor's rights with respect to all equipment, machinery, and facilities associated with the production and marketing of production payment hydrocarbons; and
- exercise rights of set off and specific performance.

In addition, the P&D Agreement customarily provides for the grant by the PP Grantor to the PP Grantee of a lien and security interest in the PP Grantor's interests in the burdened leases to secure the performance by the PP Grantor of its covenants and obligations under the P&D Agreement.<sup>272</sup>

For state law purposes, it is critically important that the lien and security interest secure only the PP Grantor's performance obligations under the P&D Agreement, and not create a recourse obligation, on the part of the PP Grantor, to satisfy the production payment. Indeed, a benefit of using a P&D Agreement is that it segregates the provisions creating such lien and security interest from the PP Conveyance, which will (hopefully) assist a court's interpretation of the documents. If the lien and security interest is granted to secure the satisfaction of the production payment, of course, the production payment will not constitute an interest in real property for state law purposes (in Texas, it will constitute a mortgage loan);<sup>273</sup> it will not constitute an economic interest in minerals in place for income tax purposes because the mortgage would be considered to breach the Alternate Source Rule,<sup>274</sup> and it would not qualify

as a "production payment" within the meaning of Section 541(b)(4)(B) of the Bankruptcy Code because it would not be "contingent on the production of liquid or gaseous hydrocarbons from particular real property."<sup>275</sup>

Assuming that the lien and security interest is properly crafted to avoid these pitfalls, then for state law purposes, the inclusion in the P&D Agreement of such a lien and security interest, as well as the other remedies described above, should not affect the characterization of the production payment. For the same reasons discussed above in Section III.C.2 of this paper,<sup>276</sup> provisions of these types are commonly found in conveyances of non-operating interests to protect the non-operating interest owner from the acts and omissions of the owner of the operating interest.<sup>277</sup> Indeed, specifically with respect to the referenced lien and security interest, recall that, in both the *Sheppard*<sup>278</sup> and *Quintana*<sup>279</sup> cases, the presence in the leases in controversy of reserved liens covering the lessee's leasehold interest to secure the payment to the lessor of the accrued revenues from the sale of production attributable to the production payments created in the leases did not alter the character of the production payments as interests in real property because the satisfaction of the production payments was conditional upon production and not an absolute obligation of the lessee/payor. As stated by the court of civil appeals in *Sheppard*, the reserved lien was "merely security for the enforcement of the right to be paid out of production. It never becomes effective until the right of such payment arises; that is, until there is production."<sup>280</sup>

This result is consistent with the holding of the Texarkana Court of Civil Appeals in *Pansy Oil Co. v. Federal Oil Co.*,<sup>281</sup> decided three years before *Sheppard*. In *Pansy*, the production payment conveyance provided that:

<sup>275</sup> 11 U.S.C.A. § 101(a)(1)(42A) (West 2010).

<sup>276</sup> See notes 266-67, *supra*, and accompanying text.

<sup>277</sup> See 2 WILLIAMS & MEYERS, *supra* note 4, § 428.6 at 482-83.

<sup>278</sup> *Sheppard v. Stanolind Oil & Gas Co.*, 125 S.W.2d 643 (Tex. Civ. App. – Austin 1939, writ ref'd).

<sup>279</sup> *State v. Quintana Petroleum Co.*, 134 Tex. 179, 133 S.W.2d 112 (1939), *reh. denied*, 134 Tex. 191, 134 S.W.2d 1016 (1940).

<sup>280</sup> 125 S.W.2d at 647.

<sup>281</sup> 91 S.W.2d 453 (Tex. Civ. App. – Texarkana 1936, writ ref'd n.r.e.).

<sup>272</sup> See Muñoz, *supra* note 2, at 233-34.

<sup>273</sup> See notes 51-60, *supra*, and accompanying text.

<sup>274</sup> See note 117, *supra*, and accompanying text.

If Seller shall fail or refuse to deliver said oil in accordance herewith, this instrument shall then, upon the happening of such event, operate as a complete conveyance and assignment of the above described oil and gas lease insofar as it covers the land above described, and contingent upon the happening of such condition we hereby, sell, convey and assign said lease together with all personal property thereon unto him, the said [Buyer], his heirs, assigns, executors, and administrators forever.<sup>282</sup>

Without addressing the issue whether the production payment in controversy constituted an interest in real property, the court held nevertheless that, because there was no absolute obligation to pay the amount of the production payment, the transaction did not constitute a mortgage loan to which the usury statutes would apply.<sup>283</sup>

Notwithstanding the foregoing discussion, the introduction into production payment documentation of a lien and security like that described above may still create confusion on the part of courts interpreting such documents. Look no further than the Fifth Circuit's decision in *In re Senior-G&A Operating Co. v. Aguillard*.<sup>284</sup> In that case, notwithstanding apparently well crafted security documents and a very careful description of their operation for the court, the Fifth Circuit highlighted the existence of the lien on the burdened leases securing the debtor-in-possession's performance of numerous covenants in the transaction documents as a prime factor supporting its conclusion that the production payment in controversy was not a real right under Louisiana law, but rather security for a loan.<sup>285</sup>

Presumably, the enactment of Section 541(b)(4)(B) of the Bankruptcy Code reduces the risk of future decisions like *Senior-G&A*. Nevertheless, it is suggested that the increased levels of bankruptcy and environmental risk described in Section III.C.2 of this paper<sup>286</sup> also exist as the result of the complete control over operations on the burdened leases that the PP Grantee is entitled to achieve upon its exercise of the remedies (including the foreclosure of the lien and

security interest) available to the PP Grantee in the P&D Agreement.

#### IV. CONCLUSION

There are, of course, numerous other issues that must be addressed in production payment transactions. It is hoped, however, that this discussion will provide a useful starting point for practitioners handling such a transaction.

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<sup>282</sup> *Id.* at 455.

<sup>283</sup> *Id.* at 457.

<sup>284</sup> 957 F.2d 1290 (5<sup>th</sup> Cir. 1992).

<sup>285</sup> *Id.* at 1296-97.

<sup>286</sup> See notes 268-71, *supra*, and accompanying text.

