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USE OF NET PROFITS INTERESTS IN FINANCING OIL AND GAS TRANSACTIONS

By: Michael P. Pearson

Author contact information:
Michael P. Pearson
Jackson Walker L.L.P.
1401 McKinney, Suite 1900
Houston, Texas 77010
mpearson@jw.com
713-752-4311

Michael P. Pearson
Jackson Walker L.L.P.
1401 McKinney, Suite 1900
Houston, Texas 77010
Telephone: (713) 752-4311
Facsimile: (713) 752-4221
mpearson@jw.com

Biography
Michael P. Pearson is a partner in the Business Transaction section and co-chairman of the Energy Practice Group for Jackson Walker. 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 currently the Chair-Elect 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 Natural Resources Law. He was also named a "Texas Super Lawyer" in the October 2007 issue of *Texas Monthly* magazine. In 2005, *Lawdragon Magazine* selected Mr. Pearson as one of the "500 Best Lawyers in America," and in 2007 as one of the "500 Top Deal Makers in America."

Publication & Speaking Engagements
Mr. Pearson has authored a number of articles relating to banking and energy matters, and has also been a frequent speaker at continuing legal education programs and seminars. Most recently, Mr. Pearson delivered a paper entitled "Gas Royalty Calculation 2005 – An Update," at the 2005 State Bar of Texas Advanced Oil, Gas and Energy Resources Law Course. That paper was later republished in the quarterly Section Report of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas.

Mr. Pearson spearheaded the development and has 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 most recently, the Energy Bar Association. Mr. Pearson will also chair the Seventh Gas and Power Institute in Fall 2008.

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USE OF NET PROFITS INTERESTS IN FINANCING OIL AND GAS TRANSACTIONS BY MICHAEL P. PEARSON*

I. INTRODUCTION

A number of interest that do not entitle their owners to participate in, or obligate them with respect to, oil and gas operations may be carved out, by grant or reservation, of the estate created by an oil and gas lease interest.[1]

The net profits interest has not received the same level of scholarly commentary[2] or judicial attention as the overriding royalty interest or the production payment. Nevertheless, because of the legal characteristics of the net profits interest and the favorable income tax treatment of net profits interests from the perspective of tax exempt investors seeking to avoid "unrelated business taxable income", net profits interests have acquired renewed significance as vehicles for oil and gas investment and finance.[3] This paper will discuss the common characteristics of the net profits interest, describe some of its current uses, provide a brief description of its treatment for federal income tax purposes, and, finally, discuss some of the issues that should be taken into account when documenting net profits interest transactions.

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[1] *See* 2 H. WILLIAMS & C. MEYERS, OIL & GAS LAW § 417 (LexisNexis 2007) (hereinafter, "2 H. WILLIAMS & C. MEYERS").

[2] *See*, *e.g.*, Sherrill, *Net Profits Interests – A Current View*, 19th ANN. INST. ON OIL & GAS LAW 165 (Sw. Legal Fdn. 1968) (hereinafter, "Sherrill"); Hubert and Taylor, *Creation and Conveyance of Oil and Gas Lease Burdens*, 31 ROCKY MTN. MIN. L. INST. 14-1 (1985) (hereinafter, "Hubert and Taylor"); Terrell, "*Overriding Royalties and Like Interests – A Review of Nonoperating Lease Interests*, ROCKY MTN. MIN. L. SPECIAL INST. Ch. 4 (1993) (hereinafter, "Terrell"); 2 H. WILLIAMS & C. MEYERS, *supra* note 1, at § 424.

[3] *See*, *e.g.*, Armbrust, *Legal Considerations for Pension Funds Investing in Oil and Gas* (1984) (hereinafter, "Armbrust"); Cross, *Current Developments in Oil and Gas Financing*, COMMERCIAL FINANCE GUIDE (Matthew Bender 1993) (hereinafter, "Cross"); Dunlap, *Current Developments in Energy Financing: Alternatives to Traditional Production – Secured Borrowing*, OIL & GAS LAW 1994 (Okla. City Univ. School of Law 1994) (hereinafter, "Dunlap I"); Dunlap, *Issues in Trade and Vendor Financing: You Scratch My Back and I'll Scratch Yours*", ADV. OIL, GAS, & MIN. L. COURSE, Paper B (St. Bar of Texas 1996) (hereinafter, "Dunlap II); Munoz, *Exotic and Alternative Financing Structures – Where Is the Market Going?*, OIL & GAS AGREEMENTS: SALES AND FINANCINGS, Paper 12 (Rocky Mtn. Min. L. Fdn. 2006) (hereinafter, "Munoz"); and 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 Mtn. Min. L. Fdn. 2006) (hereinafter, "Zlotky").

II. CHARACTERISTICS OF NET PROFITS INTERESTS

A. Comparison of Non-Operating Interests

To understand the nature of a net profits interest, it is first necessary to understand certain characteristics of its more frequently used cousins, the overriding royalty interest and the production payment. An overriding royalty interest is commonly 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.[4] 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.[5] Similarly, a production payment, or oil payment, has been 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.[6] 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 in favor of a third party.[7]

Like overriding royalty interests and production payments, 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[8] 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.[9] Unlike an overriding royalty interest or a production payment, 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 the extent that operations on the burdened lease yield "net profits".[10]

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[4] 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 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.).

[5] *In re GHR Energy Corp.*, 972 F.2d 96, 99 (5th Cir. 1992). *See* 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 418 at 351; Terrell, *supra* note 2, at 6.

[6] *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.), quoting 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 422 at 366.10. For an excellent discussion of the law relating to production payments, *see* Walker, *Oil Payments*, 20 TEXAS L. REV. 259 (1942).

[7] *See, generally*, 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 422 at 367-68.

[8] *E.g.*, *Louisiana Land & Exploration Co. v. Donnelly*¸ 394 F.2d 273 (5th Cir. 1968). *See* Terrell, *supra* note 2, at 9.

[9] *See* 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 424.1 at 438-39; Terrell, *supra* note 2, at 9; Hubert and Taylor, *supra* note 2, at 14-4, 14-5; Sherrill, *supra* note 2, at 166.

[10] *See* 1 E. SMITH & J. WEAVER, TEXAS LAW OF OIL & GAS § 2.4.D at 2-68 (LexisNexis 2007) (hereinafter, "SMITH & WEAVER"); 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 424 at 437-38.

While overriding royalty interests and production payments have well-defined, judicially recognized characteristics, there is no generally accepted method of calculating "net profits".[11] The specific items of revenue and cost taken into account in a particular net profits interest transaction will be matters of contract between the parties.[12] Most commonly, however, the term "net profits", when used in this context, refers to the excess, if any, of the proceeds from the sale of production from the burdened lease over the development, operation, production, transportation, and marketing costs, as well as the severance, ad valorem, sales, and similar taxes, associated with such hydrocarbon production.[13]

Like an overriding royalty interest (but unlike a production payment, which terminates when a specified volume of production or a specified sum of money has been received by the owner thereof), a net profits interest continues for the life of the burdened lease. Neither the overriding royalty interest, the production payment, nor the net profits interest entitle 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. All of such non-operating interests must be satisfied entirely out of production from the burdened lease. Unlike overriding royalty interests and production payments, which may be created to give their owners the right to receive their shares of production in kind, net profits interests entitle their owners only to the receipt of revenues to the extent that there exist "net profits."[14]

B. Classification of Net Profits Interests

1. Basic Principles of Texas Oil and Gas Law. The conceptual basis for the treatment by the Texas courts of net profits interests 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 net profits interests 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.[15] Some other jurisdictions hold that fugacious minerals such as oil and gas cannot be owned until they have been reduced to possession.[16]

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.

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[11] *E.g.*, *Christy v. Petrol Resources Corp.*, 691 P.2d 59, 62 (N.M. App. 1984); *Atlas Corp. v. Clovis Nat'l Bank*, 737 P.2d 225, 231 (Utah 1987). *See* Sherrill, *supra* note 2, at 166; Terrell, *supra* note 2, at 10.

[12] *See* SMITH & WEAVER, *supra* note 10, § 2.4D at 2-68; Hubert and Taylor, *supra* note 2, at 14-20.

[13] *See* Sherrill, *supra* note 2, at 165-66; Hubert and Taylor, *supra* note 2, at 14-19-14-22; 2 H. WILLIAMS & C. MEYERS, *supra* note 1, § 424 at 437-39.

[14] *See*, *generally*, Sherrill, *supra* note 2, at 166-73; Hubert and Taylor, *supra* note 2, at 14-4, 14-5; Terrell, *supra* note 2, at 9, 10.

[15] *Texas Co. v. Daugherty*, 107 Tex. 226, 176 S.W. 717, 719 (1915).

[16] *See* Section II.B.3 of this paper, *infra*.

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.[17] 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 that may be assigned or devised.[18] 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.[19]

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 concerning the nature of royalty interests is *Sheffield v. Hogg*.[20] 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 royalty clauses in the leases in question 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.[21]

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.'[22]

In so holding, the court expressly disapproved all statements in prior Texas cases that disagreed or were inconsistent with the foregoing conclusions.[23]

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[17] *E.g.*, *Stephens County v. Mid-Kansas Oil and Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923).

[18] *Caruthers v. Leonard*, 254 S.W., 779 (Tex. Comm'n App. 1923, judgmt adopted); *Bagby v. Bredthauer*, 627 S.W.2d 190, 197 (Tex. App. – Austin 1981, no writ).

[19] *Texas Oil & Gas Corp. v. Ostrum*, 638 S.W.2d 231, 234 (Tex. App. – Tyler 1982, writ ref'd n.r.e.).

[20] 124 Tex. 290, 77 S.W.2d 1021 (1934).

[21] *Id*. at 1024.

[22] *Id*. at 1027-28.

[23] *Id*. at 1025. *See* note 40, *infra*.

Although an occasional early Texas case held that overriding royalty interests do not constitute interests in land, but rather are contractual rights of the overriding royalty owner to receive its share of production revenues from the owner of the lease,[24] 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*,[25] 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

[24] *E.g.*, *Dashko v. Friedman*, 59 S.W.2d 203 (Tex. Civ. App. - Texarkana 1933, no writ). In that case, 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. *Id*. at 204-5. 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 <u>after</u> their production. *Id*. at 204.

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.

Walker, *Oil Payments*, 20 TEXAS L. REV. 259, 263 (1942). Subsequent Texas decisions clearly have repudiated the analytical approach to the characterization of royalty and similar interests represented by cases such as *Dashko*. In *Sheffield*, the Texas Supreme Court expressly disapproved cases such as *Dashko*, stating without specifically identifying the styles of 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.

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 quoted above from 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.).

[25] 107 S.W.2d 1037 (Tex. Civ. App.- Galveston 1937, no writ).

> receive some fractional portion of the oil and gas produced and saved, as does the owner of a royalty interest.[26]

Similarly, although an early federal court case applying Texas law held that a production payment payable in money constituted a lien on the hydrocarbons produced from the burdened lease and not an interest in land,[27] the Texas courts in decisions issued subsequent to Sheffield have held that production payments, whether payable in kind or in money 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.[28]

2. Application to Net Profits Interests. Although fewer Texas cases address the nature of net profits interests than consider the nature of royalty interests, overriding royalty interests, or production payments, the available Texas cases have consistently applied the principles set out in *Sheffield* and held net profits interests to be interests in land. For example, in *LaRue v. Wiggins*[29], a case involving, in part, an alleged oral agreement by the appellee to convey to the appellant an interest in the net profits accruing in the future to the parties under oil and gas leases thereafter to be acquired, the court rejected the appellant's contract action for specific performance of the oral agreement, stating that "any present interest in the net profits, if any, to accrue to appellees in the future by reason of their ownership of oil and gas leases…constitutes and is an interest in real estate within the meaning of the Statute of Frauds and the Texas Trust Act."[30] Since the alleged net profits agreement was not in writing as is required by the Statute of Frauds for conveyances of real property, the court concluded that it was unenforceable.[31]

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[26] *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 - Vada 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).

[27] *Standley v. Graham*, 83 F.2d 489 (5th Cir. 1936), *cert. denied*, 299 U.S. 593, 57 S. Ct. 115 (1936), citing the Texas Court of Appeals decision in *Dashko v. Friedman*, 59 S.W.2d 203 (Tex. Civ. App. - Texarkana 1933, no writ). The Texas Supreme Court expressly disapproved cases such as *Dashko* in *Sheffield v. Hogg*, 124 Tex. 290, 77 S.W.2d 1021, 1025 (1934). *See* note 24, *supra*.

[28] *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937); *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); *Sheppard v. Stanolind Oil & Gas Co.*, 125 S.W.2d 643 (Tex. Civ. App. - Austin 1939, writ ref'd); *McCurdy v. Harry L. Edwards Drilling Co.*, 198 S.W.2d 609, 611-12 (Tex. Civ. App. - Galveston 1946, no writ); *Prince Bros. Drilling Co. v. Fuhrman Petroleum Corp.*, 150 S.W.2d 314, 316 (Tex. Civ. App. - El Paso 1941, writ ref'd).

[29] 277 S.W.2d 808 (Tex. Civ. App. - Waco 1955, writ ref'd n.r.e.).

[30] *Id*. at 811.

[31] *Id*. *See* TEX. PROP. CODE §5.021 (West 2007).

More recently, in *T-Vestco Litt-Vada v. Lu-Cal One Oil Co.*[32], a trespass to try title action, the plaintiffs claimed title to interests in certain oil and gas leases on the basis of contracts which gave them the right to receive a portion of the net profits from the wells drilled on the leases. The issue before the court was whether the interests in controversy constituted possessory interests in land as to which a trespass to try title action could be maintained. The court quoted with approval the view of Professors Williams and Meyers that a net profits interest should be treated as being similar to an overriding royalty interest and that it should be classified as an interest in land.[33] The court stated that it need not decide whether the contracts in controversy created overriding royalty interests or net profits interests since, in either case, the interests created were non-possessory interests in land. Because these interests were non-possessory, however, the court concluded that the plaintiff was not entitled to maintain a trespass to try title action with respect thereto.[34]

A similar result was reached in *Parker v. Petro-Lewis Corp.*[35] In *Parker*, plaintiffs brought an action in McMullen County to quiet title to their net profits interest in production from an oil and gas lease covering lands in that county. The district court granted the defendant's plea of privilege and transferred venue in the case to Harris County, and the plaintiffs appealed. The issue on appeal was whether the net profits interest was an interest in land, which would make venue mandatory in the county where the land covered by the burdened lease was located.[36] In reversing the judgment of the trial court and remanding the case for trial on the merits in McMullen County, the court of appeals stated, "It is well established in Texas that a royalty and an overriding royalty in minerals are considered 'land' for the purpose of fixing venue in suits for recovery of such interest or damages thereto. A net profits interest is also an interest in land."[37] As such, the court concluded that the proper venue was the county where the burdened lease was located.[38]

One final Texas case merits discussion. The court of appeals' decision in *Lebus v. Lebus*[39] is occasionally cited for the proposition that, contrary to the decisions in the preceding cases, a net profits interest is merely a contractual right in the nature of a profit sharing agreement under Texas law.[40] In *Lebus*, the estate of one brother filed suit against the other brother to impose a trust upon, and for an accounting of, certain funds alleged to be owed the decedent under an oral agreement to deliver to the decedent a portion of the net profits from the

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[32] 651 S.W.2d 284 (Tex. App. - Austin 1983, writ ref'd n.r.e.).

[33] *Id*. at 292, citing 2 H. WILLIAMS & C. MEYERS, *supra* note 1, §424.1 at 439.

[34] 651 S.W.2d at 292.

[35] 663 S.W.2d 905 (Tex. App. - San Antonio 1983, no writ).

[36] *Id*. at 906.

[37] *Id*. at 906-7.

[38] *Id*. at 908. *See also Madera Production Co. v. Atlantic Richfield Co.*, No. 06-01-00075-CV, 2003 Tex. App. LEXIS 2164 at #13 (Texarkana March 13, 2003, no pet.).

[39] 269 S.W.2d 506 (Tex. Civ. App. - Fort Worth 1954, writ ref'd n.r.e.).

[40] *E.g.*, 2 H. WILLIAMS & C. MEYERS, *supra* note 1, §424.1 at 439 n. 2; Terrell, *supra* note 2, at 10; Hubert and Taylor, *supra* note 2, at 14-9..

operation of an oil and gas lease. The district court granted the defendant's motion for summary judgment that the decedent take nothing, but the court of appeals reversed and remanded the case for trial on the merits, concluding that the plaintiff estate's pleadings and affidavits raised substantial fact issues about the existence of the alleged oral agreement and whether the decedent was owed money as a result thereof.[41] In so holding, the court noted that the decedent never claimed "any title, legal or equitable", in or to the oil and gas lease in controversy.[42] The court then concluded that the pleadings indicated that no relationship of partnership existed between the decedent and his brother as to the subject lease that would entitle the decedent to an interest in the net profits therefrom, so that, at most, the decedent's claim was premised on a "mere profit sharing agreement" between the two.[43]

Since the plaintiff estate's pleadings did not claim any title or interest in the oil and gas lease in controversy, and since its affidavits contained statements to the effect that the decedent had expressly disclaimed any direct title to or interest in such lease, Lebus appears to be factually distinguishable from, and its holding does not, in fact, appear to be inconsistent with, the results reached in *LaRue*, *T-Vestco*, and *Parker*.

Based upon the foregoing discussion, it seems clear that, consistent with the principles stated by the Texas Supreme Court in *Sheffield* as applied by the courts of appeals in *LaRue*, *T-Vestco*, and *Parker*, net profits interests are deemed under Texas law to be analogous to overriding royalty interests and, therefore, constitute presently vested, non-possessory interests in real property.

3. Net Profits Interests in States Other Than Texas. Although we have not attempted to research exhaustively the characterization of net profits interests under the laws of states other than Texas, we have identified a small number of non-Texas cases addressing this issue that merit discussion.

A common theme in many non-Texas cases is that, unlike the Texas courts (which, based on the principles stated in *Sheffield*, characterize oil and gas interests as interests in land essentially as a matter of public policy), the courts in some other states are reluctant to make generalized statements about the legal character of net profits interests. For example, in New Mexico, a state that, like Texas, has adopted the "ownership in place" theory of mineral ownership[44] and has characterized most types of oil and gas interests as interests in land,[45] the

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[41] 269 S.W.2d at 512-13.

[42] *Id*. at 510.

[43] *Id*. at 511.

[44] *See* 1 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §203.3 at 47 (LexisNexis 2007) (hereinafter, "1 H. WILLIAMS & C. MEYERS").

[45] 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); and 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), if created for the duration of a freehold estate, all are characterized as interests in real property. *See* 1 H. WILLIAMS & C. MEYERS, *supra* note 44, §214 at 165.

New Mexico Court of Appeals, in *Christy v. Petrol Resources Corp.*[46], refused to apply such a general characterization to net profits interests generally, stating:

> …[T]here is no body of law clearly defining the net profits interest, its nature, and its incidents. The only thing that can be said with any assurance is that a net profits interest may or may not be an interest in land in that the nature of the interest and the rights of its owner must be determined from the provisions of the instrument which created it.[47]

Thus, in *Christy*, a suit to quiet title to a net profits interest, the court of appeals affirmed the trial court judgment dismissing the quiet title claim, holding that the net profits interest in controversy was an interest in only the cash bonus paid by the lessee to the lessor in the relevant transaction, was not an interest in the proceeds of production, was therefore contractual in nature, and thus not the proper subject matter for a quiet title suit.[48] In *Team Bank v. Meridian Oil Inc.*,[49] the New Mexico Supreme Court interpreted a conveyance of a "net overriding royalty interest…in and to the Minerals in and under, and if as and when produced, saved, and sold from, the Subject Lands…equal to…(75%) of the Net Proceeds attributable to the Subject Interests…" as creating an overriding royalty interest (notwithstanding that the interest conveyed was measured by a percentage of the net proceeds from production) and concluded that the overriding royalty interest was an interest in real property.[50]

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.[51] Thus, both royalty interests[52] and overriding royalty interests[53] have been held to constitute interests in personal property. Consistent with these holdings, the Kansas Supreme Court, in *Kumberg v. Kumberg*,[54] interpreting a testamentary devise of an interest in the "net profits" from land devised by the testator, concluded that the devised interest in net profits included oil and gas royalties and overriding royalties from

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[46] 102 N.M. 58, 691 P.2d 59 (N.M. Ct. App. 1984).

[47] 691 P.2d at 62. Similar approaches are found in *Ferguson v. Coronado Oil Co.*, 884 P.2d 971 (Wyo. 1994), and *Atlas Corp. v. Clovis Nat'l Bank*, 737 P.2d 225 (Utah 1987).

[48] 691 P.2d at 63-64.

[49] 118 N.M. 147, 879 P.2d 779 (1994).

[50] 691 P.2d at 781, citing *Uhden v. New Mexico Oil Conservation Comm'n*, 112 N.M. 528, 817 P.2d 721, 723 (1991).

[51] *See* 1 H. WILLIAMS & C. MEYERS, *supra* note 44, §214.1 at 172-73.

[52] *E.g. Lathrop v. Eyestone*, 170 Kan. 419, 227 P.2d 136 (1951).

[53] *Campbell v. Nako Corporation*, 195 Kan. 66, 402 P.2d 771 (1965).

[54] 232 Kan. 692, 659 P.2d 823 (1983).

production from the testator's lands and itself constituted an interest in personal, and not real, property.[55]

In interpreting a reservation in a lease assignment of "fifty percent of the net profits realized by [the lessee] from all operations on" the subject leases, the Wyoming Supreme Court, in *Ferguson v. Coronado Oil Co.*,[56] reached a similar result, concluding that such reserved net profits interest constituted a separate, identifiable personal property right under Wyoming law.[57] Our research has not discovered any cases decided by the Oklahoma courts addressing specifically the characterization of net profits interests under Oklahoma law. 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.[58] If that is the case, the net profits interest may be expected to be characterized as an interest in personal property under Oklahoma law as well.

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 net profits interest transactions affecting oil and gas leases covering land in states other than Texas obtain opinions from local counsel in the relevant states addressing the legal characterization of a net profits interest under the laws of such state.

C. Tax Treatment of Net Profits Interests

A complete discussion of the federal income tax treatment of net profits interests is beyond the scope of this paper. For purposes of the investment and financing transactions for which net profits interests are currently used most frequently, however, there are two critical aspects of such tax treatment that merit discussion: (a) the characterization of a net profits interest as an "economic interest in minerals in place"; and (b) its characterization as a "royalty" for purposes of Section 512(b)(2) of the Internal Revenue Code of 1986, as amended (as so amended, the "Code"), relating to the "unrelated business taxable income" ("UBTI") of certain tax exempt organizations ("TEOs") .

1. Classification of Mineral Interests. An analysis of the federal income tax consequences of owning interests in oil and gas properties generally begins with an understanding of the "tax" nature of the relevant interest. For example, an "operating interest", for tax purposes, is an interest pursuant to which the owner has the right to undertake oil and gas

[55] 659 P.2d at 830.

[56] 884 P.2d 971 (Wyo. 1994).

[57] *Id*. at 977-78. The court cited the Kansas Supreme Court's decision in *Kumberg v. Kumberg*, 232 Kan. 692, 659 P.2d 823 (1983), in support of its holding.

[58] *See* 1 H. WILLIAMS & C. MEYERS, *supra* note 44, §214.2 at 175-78.

exploration, development, and production activities. The owner of an operating interest is personally liable for the costs of exploring, developing, and operating the oil and gas property.[59]

A "non-operating interest" is an interest that entitles its owner to a share of the oil, gas or other minerals produced from a property, but does not entitle the owner to participate in the exploration, development and operation of the property. Consequently, the owner of a non-operating interest is not personally liable for the costs of exploring, developing, and operating the property. Non-operating interests generally include royalties, overriding royalties, net profits interests, and production payments (to the extent not treated as loans under Section 636 of the Code).[60]

Although there is no standard definition of a net profits interest for federal income tax purposes,[61] a review of relevant authorities indicates that a mineral interest will be characterized as a net profits interest if it: (a) entitles the holder to a specified share of the net profits derived from the exploration, development and operation of the burdened property; (b) continues for the life of the burdened property; (c) imposes no liability on the holder for the costs of exploring, developing and operating the burdened property in excess of the gross income from the property; (d) affords the holder no right to participate in the management of operations on the burdened property; and (e) satisfies the tests for qualification as an economic interest in mineral property.[62] Qualification will be determined based on all the facts and circumstances and the conduct of the parties.[63]

In Section IV of this paper, we will examine how certain provisions of the documents creating the net profits interest affect whether the interest created meets the foregoing criteria.

2. Economic Interest. The first issue to be considered is whether a net profits interest constitutes an 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 the taxpayer must look for a return of his capital.[64] 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

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[59] *See* Treas. Reg. §1.614-2(b).

[60] *See* Treas. Reg. §1.614-5(g).

[61] *See Oil and Gas Transactions*, Tax Mgmt. Portfolio (BNA) No. 605, at A-11 (2002); *G.C.M.* 38, 216 (December 28, 1979); *T.A.M.* 1999-18-002 (January 15, 1999).

[62] *Callahan Mining Corp. v. Commissioner*, 428 F.2d 721 (2d Cir. 1970), *cert. denied*, 400 U.S. 903 (1970); *Rev. Rul.* 73-541, 1973-2 C.B. 206; Rev. Rul. 69-179, 1969-1 C.B. 158.

[63] *See G.C.M.* 38,216 (December 28, 1979).

[64] Treas. Reg. §1.611-1(b)(1).

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."[65] The latter part of the test has been interpreted to preclude any possibility of satisfaction from a source other than depletable production income.[66]

The courts initially struggled with the application of the economic interest requirement in the context of a net profits interest. The Supreme Court first addressed the issue in *Helvering v. O'Donnell*.[67] There, the purchaser of corporate stock agreed to pay the seller a share of the net profits from the operation of oil and gas leases held by the corporation. The Court held that the agreement was a mere personal covenant and not an economic interest in the properties themselves, even though the purchaser had agreed to liquidate the corporation. Shortly thereafter, in *Helvering v. Elbe Oil Land Development Co*., the Court held that a contract providing for the sale of oil and gas leases and related assets in exchange for fixed payments and a share of the net profits from operation of the properties was a sale of the entire economic interest in the minerals burdened by the transferred leases, in effect refusing to treat the share of net profits as a separate economic interest.[68] The transaction documents had characterized the transaction as a sale and did not refer to the share of net profits as an interest in the mineral properties themselves.

Later, in *Kirby Petroleum Co. v. Commissioner*, the Court held that where a lessor retained both a royalty and a right to a share of the lessee's net profits, the net profits interest was an economic interest in the nature of rent or royalty paid by the lessee for the privilege of extraction.[69] In a companion case, *Burton-Sutton Oil Co., Inc. v. Commissioner,* the Court held that the failure of an assignor of a lease to retain a royalty in addition to a net profits interest did not alter the nature of the net profits received as depletable gross income.[70] The Court, in *Kirby*, refused to expressly overrule *O'Donnell* and *Elbe*, however. Instead, it attempted to distinguish them on the grounds that, in *O'Donnell*, the taxpayer was a "stranger" to the lease and, in *Elbe*, the conveyance contemplated an absolute sale of all of the seller's interest in the properties.[71] Finally, in *Commissioner v. Southwest Exploration Co*., the Court again addressed the economic

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[65] *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.

[66] *See e.g., Anderson v. Helvering*, 310 U.S. 404 (1940); *Kirby Petroleum Co. v. Commissioner*, 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").

[67] 303 U.S. 370 (1938).

[68] 303 U.S. 372 (1938).

[69] 326 U.S. 599, 604 (1946).

[70] 328 U.S. 25 (1946).

[71] 326 U.S. at 606.

interest concept in the context of a net profits interest.[72] There, net profits interests were granted to upland landowners for the right to drill wells on their land into offshore mineral deposits. The Court held that the net profits interests were economic interests in the mineral deposits entitling the landowners to depletion on the net profits paid to them.

Subsequent authorities have generally ignored *Elbe* and followed *Kirby, Burton-Sutton* and *Southwest Exploration Co*. in holding that an otherwise qualifying net profits interest in oil, gas or other minerals in place is an economic interest in the nature of a royalty or overriding royalty.[73] Thus, the Fifth Circuit specifically held that a net profits interest is a royalty in *Louisiana Land and Exploration Co. v. Donnelly*.[74] Likewise, in *Revenue Ruling 73-541* the Service ruled that where a lessee has sole control over operations, furnishes all capital for exploration and development, and is solely liable for loss if the operation should prove unprofitable, the lessor's retained net profits interest is an economic interest and a royalty paid for the privilege of extraction.[75]

Based on the foregoing, it is now well established that net profits interest constitute economic interests in minerals in place. As a result, after a net profits interests has been created, all revenues attributable to the net profits interest paid to the owner thereof are ordinary income to the owner subject to depletion.

3. UBTI Analysis. The second issue is whether a net profits interest constitutes a "royalty" for purposes of Section 512(b)(2) of the Code.[76] Section 511 of the Code[77] imposes a tax on the UBTI of most TEOs. Pursuant to Section 512(a)(1) of the Code[78], UBTI includes the gross income derived by a TEO from any unrelated trade or business regularly carried on by it. Section 513(a) of the Code[79] generally defines "unrelated trade or business" to mean any trade or business the conduct of which is not substantially related to the performance of the TEO's exempt function. Thus, an activity that is regularly carried on and that is not related to the performance of a TEO's exempt function will, subject to certain exceptions

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[72] 350 U.S. 308 (1956).

[73] *See, e.g., Callahan Mining Corp. v. Commissioner*, 428 F.2d 721 (2d Cir. 1970), *cert. denied*, 400 U.S. 903 (1970); *United States v. Thomas*, 329 F. 2d 119 (9th Cir. 1964); *Farwell v. Commissioner*, 35 T.C. 454 (1960). Exceptions have generally involved various downstream processors typically found to hold mere "economic advantages" with no capital investment in the oil, gas or other minerals in place. *See e.g., Hudson Engineering Corp. v. Commissioner*, 183 F.2d 180 (5th Cir. 1950); *Scofield v. La Gloria Oil and Gas Co.*, 268 F.2d 699 (5th Cir. 1959). Cases similar to *O'Donnell*, involving deferred payments for stock, have also found no economic interest. *See, e.g., Tuttle v. United States*, 101 F.Supp. 532 (Ct. Cl. 1951); *Warren v. United States*, 171 F.Supp. 846 (Ct. Cl. 1959).

[74] 394 F.2d 273, 278 (5th Cir. 1968).

[75] 1973-2 C.B. 206. *See also Rev. Rul.* 92-25, 1992-1 C.B. 196 (net profits interest is a royalty representing a share of gross production measured by net profits); *Rev. Rul*. 94-48, 1994-2 C.B. 3, (net profits interest is a royalty entitling holder to a share of the Section 29 credit).

[76] I.R.C. §512(b)(2).

[77] I.R.C. §511.

[78] I.R.C. §512(a)(1).

[79] I.R.C. §513(a).

and modifications, give rise to UBTI if the activity constitutes a "trade or business." 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 with respect to the TEO.[80]

Unless derived from debt-financed property, UBTI generally does not include passive investment income. Subject to the debt-financed property rules of Section 514 of the Code,[81] Section 512(b)(2) of the Code specifically excludes from UBTI all income from "royalties (including overriding royalties) whether measured by production or by gross or *taxable income* from the property." (*emphasis added)*[82] The unrelated business income tax was first enacted as part of the Revenue Act of 1950. With reference to what is now Section 512(b)(2), the accompanying Senate Report stated:

> The House Report indicated that … the term 'royalties' would, of course, include overriding royalties. Your committee has amended the bill to include overriding royalties specifically in the term royalties and to make it clear that royalties may be measured by production or by gross or *net income* from the property. (*emphasis added*).[83]

The phrase "measured by *taxable income*" has not been applied literally by the courts or the Internal Revenue Service (the "Service"). In other words, a net profits interest may qualify as a royalty or overriding royalty within the meaning of Section 512(b)(2) even though "net profits" are not equivalent to or defined with reference to "taxable income."[84]

The courts and the Service have addressed the treatment of net profits interest as royalties in the context of Section 512(b)(2) of the Code on a number of occasions. In *United States v. The Robert Welch Foundation*, a decedent's estate conveyed oil and gas working interests to two operating companies controlled by the estate, reserving a 100 percent net profits interest that was subsequently distributed to a private foundation and other beneficiaries. The Service argued that the net profits interest was in substance a working interest because it was charged with a portion of production costs, produced the income equivalent of a working interest, and was effectively owned and operated by the foundation through its control of the operator. Affirming the district court's rejection of the Service's argument, the Fifth Circuit stated:

> [I]t would deny to the facts their plain and compulsory meaning to hold that the form into which the payments were cast by the contracts and the action of the parties resulted in such payments

[80] *See Rev. Rul.* 69-179, 1969-1 C.B. 158; I.R.C. § 512(c).

[81] I.R.C. §514.

[82] I.R.C. §512(b)(2). This paper addresses only the application of Section 512(b)(2) of the Code. It does not address whether the activities of a TEO that owns a net profits interest will constitute a "trade or business" within the meaning of Section 513(a) of the Code without regard to the express exception set forth in Section 512(b)(2).

[83] S. Rep. No. 2375, 81st Cong., 2d Sess. 3,083 (1950).

[84] *See United States v. The Robert Welch Foundation*, 334 F.2d 774 (5th Cir. 1964); *G.C.M.* 38,216 (December 28, 1979).

> being taxable income. [T]he burden of the Government's claim is that there is a lack of reality in what was done, and that while the contract documents were so framed as to create the appearance of overriding royalties, nevertheless the substance of the transactions left it with working interests. To agree with these views would call for a departure from the concepts of the terms, 'overriding royalties' and 'working interests.'[85]

The Service announced that it would not follow *Welch in Revenue Ruling* 69-162, stating it would continue to review transfers of mineral interests by TEOs to controlled corporations and characterize the payments according to their substance.[86] The Service found an opportunity to review such a transfer in *General Counsel Memorandum* 38,216, where a TEO purchased working interests and then assigned them to unrelated operators, reserving 100 percent of the net profits from the assigned interests.[87] Looking to the substantive economic relationships created by the assignments, the Service concluded that the assignments did in substance create net profits interests and that the NPIs were royalties excluded from UBTI under Section 512(b)(2) of the Code. The Service found no basis for treating a net profits interest as a working interest simply because the size of the interest exceeds a certain percentage, emphasizing that the key distinction between operating interests and non-operating interests, like royalties, is that the holder of a non-operating interest bears no personal liability for development and operating costs.[88]

D. Bankruptcy Analysis of Net Profits Interests.

Among the most significant issues to be analyzed by any party purchasing a net profits interest for investment purposes or pursuant to a financing transaction is how the bankruptcy of the owner of the burdened lease will affect the relevant net profits interest. In particular: (a) will the net profits interest constitute property of the estate of the owner of the burdened lease under Section 541 of the Bankruptcy Code; and (b) will the owner of the burdened lease be entitled to assume or reject the conveyance document creating the net profits interest as an executory contract under Section 365 of the Bankruptcy Code?

1. Bankruptcy Code Section 541. Section 541 of the Bankruptcy Code defines property of the debtor's estate to consist of "all legal or equitable interests of the debtor

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[85] 334 F.2d at 774-775.

[86] 1969-1 C.B. 158.

[87] December 28, 1979. *See also G.C.M.* 35,331 (May 7, 1973) (payments under net profits interests are royalties for purposes of U.S.-Swiss treaty, as they are for purposes of 512(b)(2) and 543(a)); *P.L.R.* 77-41-004 (July 16, 1977) (facts and holding essentially identical to *G.C.M.* 38,216); *P.L.R.* 82-14-007 (December 22, 1981) (right to convert, following a defined payout period, a portion of its lessor's royalty into net profits interest or working interest will not cause loss of benefit of Section 512(b)(2) unless and until converted to a working interest); *P.L.R.* 82-26-160 (April 6, 1982) (retained nets profits interest is a royalty for Section 512(b)(2)); *P.L.R.* 88-39-016 (June 28, 1988) (100% nets profits interest is a royalty for Section 512(b)(2)); *P.L.R.* 88-48-066 (September 8, 1988) (income from carved-out net profits interests is not UBTI); P.L.R. 93-20-052 (February 25, 1993)(retained net profits interest is a royalty for Section 512(b)(2)).

[88] *Id.*

in property as of the commencement of the case."[89] 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.[90]

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 others more than they exist at the commencement of the case. [T]he trustee . . . could take no greater rights than the debtor himself had.[91]

This reasoning has consistently been applied by the courts.[92]

Neither the former Bankruptcy Act nor the current Bankruptcy Code provides rules for determining whether a debtor owes a debt or owns any property. It is always necessary to use state law to determine ownership of property of the estate.[93]

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."[94]

Net profits interests have not received the direct judicial consideration in a bankruptcy context that production payments have received.[95] Indeed, pursuant to a 1994 amendment to the Bankruptcy Code,[96] production payments are, as a general matter, expressly excluded from the Bankruptcy Code's definition of property of the debtor's estate.[97] Nevertheless, as discussed

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[89] 11 U.S.C.A. §541(a)(1) (West 2007).

[90] *U.S. v. Whiting Pools Inc.*, 462 U.S. 198, 103 S.Ct. 2309, 2313-14, 2316-17 (1983).

[91] H.R. No. 95-595, 95th Cong., 1st Sess. (1977) 367-8, U.S. CODE CONG. AND ADMIN. NEWS 1978 at 6323.

[92] *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.")

[93] *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 (15th ed. 2003).

[94] *DeVaughn v. Hutchinson*, 165 U.S. 566, 17 S.Ct. 461. 462 (1897). *See Brown v. Commissioner*, 1 80 F.2d 946, 950 (5th Cir. 1950).

[95] *See* notes 24 and 27, *supra*.

[96] Pub. L. 103-394, §208(b) (1994).

[97] 11 U.S.C.A. §541(b)(4)(B) (West 2007).

above in Section II.B of this paper, under Texas law, net profits interests have been held to constitute presently vested, non-possessory interests in real property. Similarly, under the laws of the states surveyed in our research (New Mexico, Kansas, Wyoming, and Oklahoma), net profits interests created substantially as described later in this paper may be expected to be treated as interests in either real property or identifiable personal property. As such, if, after the execution and recording of the conveyance document creating a net profits interest, the owner of the burdened lease (and the grantor of the net profits interest or its successor in interest), becomes subject to a bankruptcy proceeding, the net profits interest, to the extent that it affects and pertains to oil and gas leases located in any of the indicated states, should not constitute property of the estate of the debtor (in this case, the owner of the burdened lease) within the meaning of Section 541 of the Bankruptcy Code.

2. Bankruptcy Code Section 365. 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.[98] 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."[99]

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.[100] 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.[101] The effect of the breach is to permit the creditor to seek allowance of any claim for damages under Section 502 of the Bankruptcy Code.[102]

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.[103] 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

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[98] 11 U.S.C.A. §365(a) (West 2007).

[99] S.REP. No. 989, 95th Cong., 2d Sess. (1978); 58, U.S. CODE CONG. & ADMIN. NEWS (1978) 5787, 5844

[100] 11 U.S.C.A. §365(b) (West 2007).

[101] 3 COLLIER ON BANKRUPTCY §365.09[1] (15th ed. 2007).

[102] 11 U.S.C.A. §502 (West 2007). *See* COLLIER ON BANKRUPTCY §365.09[1] (15th ed. 2007).

[103] *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] (15th ed. 2007).

nondebtor of the conveyed interests because rejection is not the equivalent of contract rescission.[104] 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.[105]

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 of the other."[106] Because this definition was originally formulated by the noted bankruptcy expert, Professor Vern Countryman, it is known as the "Countryman Definition".[107]

Under the Countryman Definition, it seems clear that even if a net profits interest were characterized under applicable state law as a mere contract right and not as a freehold interest in real property or identifiable personal property, a properly drafted net profits interest conveyance should not be deemed to constitute an executory contract under Section 365. Upon the execution and recording of such a conveyance document, all obligations of the grantor/owner of the burdened lease and the owner of the net profits interest regarding the creation and transfer of the net profits interest itself will be complete. As such, the only remaining obligations to be performed under the conveyance document - the calculation and payment of net profits, the covenants regarding the operation of the burdened leases, and the covenants regarding production, accounting, and reporting - all are owed by the owner of the burdened lease. In the

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[104] *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).

[105] Andrew, "*Executory Contracts in Bankruptcy: Understanding 'Rejection*,'" 59 U. COLO. L. REV. 845, 851 (1988).

[106] *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).

[107] *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 (15th ed. 2007).

absence of unperformed, reciprocal obligations owed to each other by the grantor/owner of the burdened lease and the owner of the net profits interest, a necessary element of the Countryman Definition is missing.

Assuming the bankruptcy courts' continued application of the Countryman Definition, then in the event of a bankruptcy by the owner of the burdened lease, it seems clear that a properly drafted net profits interest conveyance should not be treated as an executory contract under Section 365 of the Bankruptcy Code.

III. CURRENT USES OF NET PROFITS INTERESTS

Historically, net profits interests have been used in a variety of ways in conventional oil and gas transactions – as consideration to a lessor in a leasing transaction in addition to the customary cash bonus, delay rentals, and lessor's royalty; as additional non-cash consideration to the seller of oil and gas properties in circumstances when the seller requires compensation for the buyer's future development of prospects identified but not developed by the seller; as an alternative to a reserved overriding royalty interest in a farmout transaction.[108]

Particularly over the last decade, however, because net profits interests permit their owners to acquire revenue-generating oil and gas interests without subjecting them to personal liability for the associated costs, and because of the favorable income tax treatment of net profits interests from the standpoint of UBTI, net profits interests have become increasingly popular vehicles for hedge funds, other private equity funds, TEOs, and industry service providers and suppliers to provide equity and debt capital to the upstream sector of the oil and gas industry.

A. Direct Investment by Private Equity.

The oil and gas industry has always had a voracious appetite for sources of capital, whether by means of farmouts, joint ventures, or similar transactions with other industry participants, or the public capital markets, or bank or mezzanine finance, or private equity investment.[109] Until recently, the crippling or failure of many lending commercial banks active in energy lending as the result of the collapse of crude oil prices in the 1980s had limited the availability of conventional, borrowing-base, production-secured oil and gas lending by commercial banks to relatively low risk loans to only the strongest borrowers already possessing strong balance sheets and cash flow.[110] This circumstance forced many producers to look beyond commercial banks for financing.

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[108] *See* Sherrill, *supra* note 2, at 181-86; Hubert and Taylor, *supra* note 2, at 14-12; Terrell, *supra* note 2, at 9.

[109] See Zlotky, *supra* note 3, at 3; Muñoz, *supra* note 3, at 1.

[110] *See* Cross, *supra* note 3, at 5; Dunlap I, *supra* note 3, at 1. The principal issue for commercial banks in this regard relates to the serious impact on the yield over the cost of funds of a commercial bank that would result from a loss or required reserve for loss associated with a production-secured loan "gone bad." By focusing on larger loans to extremely creditworthy borrowers, banks reduce the risk of a loss or a required reserve for loss and afford themselves a chance to enjoy a return sufficient to justify the administrative expense of the loan. *See* Dunlap I, *supra* note 3, at 1.

Since 2000, oil and gas commodity prices have steadily risen to their current, historic highs, which has resulted in a greater of number of commercial banks more aggressively pursuing loans in the middle and lower energy markets.[111] Nevertheless, commercial banks still cannot provide all the capital required by the oil and gas industry, particularly when the risk presented by the proposed financing is outside the parameters within which banks are permitted to make loans.[112]

This need for capital, together with high commodity prices, has resulted in the entry into the marketplace of many other sources of capital. Among the most active of these additional capital sources have been private equity funds. Since many investors in private equity funds are TEOs – for example, pension plans, foundations, and educational endowments – most private equity funds place great emphasis on avoiding or minimizing investments that will cause their TEO investors to incur UBTI.[113] The income allocable to investors who, either directly or through ownership of an interest in a tax "flow-through" entity such as a partnership or limited liability company, acquire and own operating interests is considered active business income that is subject to tax as UBTI.[114] As discussed in Section II.C of this paper, however, the income allocable to the owner, either directly or through ownership of an interest in a tax flow-through entity, of a royalty interest or a net profits interest is considered passive income that does not constitute UBTI.[115]

As a result, a net profits interest is a very desirable vehicle for a private equity fund with tax exempt investors to use to acquire, either directly or through ownership interests in a partnership or limited liability company, interests in oil and gas properties. No only does a net profits interest satisfy the private equity fund's requirements regarding the avoidance of UBTI, it provides the investor with protection in the event of the bankruptcy of the owner of the burdened lease, and it eliminates the need for the investor to make additional contributions of investment capital to pay capital and operating expenses. In addition, since a net profits interest remains in effect for the life of the burdened lease, there is no fixed limit on the return to the private equity fund from its ownership of the net profits interest.[116]

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[111] *See* Muñoz, *supra* note 3, at 1.

[112] Generally, financial institutions making production-based loans follow two general guidelines: (a) loan amounts are based on 40% to 60% of the present value of future net revenues of the proved producing reserves underlying the properties supporting the loan; and (b) loan repayment from net revenues for the properties supporting the loan should occur before 50% of proved producing reserves have been depleted. Different banks approach these guidelines differently, but in each case, these factors create the "equity cushion" that permits the financial institution to make the loan at a reasonable rate of interest. When the "equity cushion" is less than described above, the risk presented by the loan and, correspondingly, the return required by the lender for making the loan, will be greater. *See* Cross, *supra* note 3, at 4, 5.

[113] *See* Muñoz, *supra* note 3, at 2; Zlotky, *supra* note 3, at 3, 4.

[114] I.R.C. §513(b).

[115] *See* notes 85-88 and accompanying text.

[116] *See* Dunlap I, *supra* note 3, at 11.

Recently, this author had the opportunity to work on a transaction involving such a private equity investment in oil and gas through the use of a net profits interest. In general, the transaction was structured as follows:

(1) An oil and gas exploration and production company and an investment banker sponsored the creation of two funds, one known as the "Operating Fund" and the other as the "Royalty Fund", to make investments in U.S. onshore oil and gas properties. Each fund made a private offering of limited partner interests to a select group of qualified U.S. investors. Interests in the Royalty Fund were offered exclusively to organizations that qualified as TEOs; no such restrictions were placed on the investors to whom interests in the Operating Fund were offered.

(2) The objective of the Operating Fund was to acquire operating interests in mature, producing oil and gas properties that included substantial proved developed producing reserves. The general partner of the Operating Fund was to attempt to improve the investment returns from the acquired properties through reserve development and replacement, improved operating efficiencies, and enhanced recovery operations.

(3) The primary objective of the Royalty Fund was to acquire from the Operating Fund net profits interests carved out of and burdening the operating interests acquired by the Operating Fund. As such, the Royalty Fund provided a means by which TEOs desiring to invest in the sponsoring oil and gas company's reserve acquisition program could do so in a tax efficient manner.

(4) The two funds entered into an agreement setting forth the criteria for determining when the Operating Fund would make an acquisition of oil and gas properties and when and at what price the Royalty Fund would acquire a net profits interest in the properties acquired by the Operating Fund.

(5) If the Operating Fund elected to make an acquisition, it was to form a special purpose entity ("SPE") to acquire the relevant properties. Upon its acquisition of such properties, the SPE would convey to the Royalty Fund a net profits interest burdening all of the acquired oil and gas properties.

(6) Each SPE was to finance a portion of the purchase price of each acquisition with borrowings from one or more commercial lenders, secured by first liens against and security interests in the properties acquired by the SPE. It was contemplated that the Royalty Fund would incur no indebtedness.

(7) Each fund hedged its exposure to fluctuating commodity prices by entering into fixed-for-floating swap contracts providing for periodic payments at a fixed rate in exchange for periodic payments at an objective floating rate, both as applied to a fixed notional volume of hydrocarbons. The swap counterparties were, for the SPE, one of its commercial lenders and, for the Royalty Fund, an

affiliate of the investment banker. The hedging transactions of each fund were entered into on an arms-length basis, independently of the other fund.

(8) On entering into its hedging transaction, the Royalty Fund was required to grant to the hedge counterparty a lien against and a security interest in its net profits interest to secure its obligations under the hedge contract. The SPE was required to grant similar liens and security interests on the acquired properties that, by agreement, were made *pari passu* with the first liens securing the loans from the commercial lenders to the SPE.

The original transaction was concluded in 2003 and remained in place until the Operating Fund sold its interests in the acquired properties to a third party, together with the Royalty Fund's net profits interest, in late 2007.

B. "Equity Kicker" Transactions

Net profits interests are also well-suited for use in connection with equity-enhanced financings, sometimes referred to as "equity kicker" transactions. The typical equity kicker transaction in the oil and gas industry involves a senior secured credit facility at a negotiated rate of interest that is higher than that provided for in a conventional credit facility, with yield enhancement to the lender by means of a direct equity interest in either the borrower or the borrower's assets.[117] This type of financing has become popular, in particular, with a number of hedge funds having an appetite for higher-risk projects that are seeking enhanced returns for their investors.[118] The typical borrower in this type of transaction is a thinly capitalized oil and gas producer for whom conventional commercial bank lending is not a viable option and who needs capital at an accelerated rate to finance drilling and other operational activities.[119]

The equity feature in this type of transaction is in lieu of an unacceptably high rate of interest on a debt instrument and compensates the lender for the increased risk in the transaction by permitting the lender to participate with the borrower in the potential "upside" value of the operations financed.[120] If the equity feature calls for direct equity participation by the lender in the borrower, the equity participation generally takes the form of a specified number of shares of common stock of the borrower, warrants or options for common stock, preferred stock convertible to common stock, participation rights, or similar rights.[121]

If the equity feature involves participation by the lender in the borrower's assets, the equity participation usually takes the form of a net profits interest or overriding royalty interest. Working or operating interests are generally inappropriate for this purpose because their tax consequences are inconsistent with the federal income tax objectives of most hedge funds and other private equity funds and these interests would obligate the lender to make additional

[117] *See* Muñoz, *supra* note 3, at 10; Dunlap I, *supra* note 3, at 7.

[118] *See* Muñoz, *supra* note 3,at 2; Zlotky, *supra* note 3, at 12.

[119] *See* Muñoz, *supra* note 3, at 2.

[120] *See* Dunlap I, *supra* note 3, at 7.

[121] *See* Muñoz, *supra* note 3, at 10; Dunlap I, *supra* note 3, at 8.

contributions of investment capital to pay subsequent capital and operating expenses, which may not be permissible under the organizational documents of a particular fund.[122] Even an overriding royalty interest has drawbacks from the borrower's perspective when used for this purpose since it would permit the lender to benefit from participation in the borrower's oil and gas assets even if production from the assets is not sufficient to allow the borrower to realize a profit in excess of operating expenses.[123]

Based on the foregoing, the net profits interest is the ideal form of "equity kicker" because (a) its tax consequences are consistent with the tax objectives of the private equity funds who provide much of this type of finance, (b) it eliminates the need for the lender to make additional contributions of investment capital to pay subsequent capital and operating expenses, (c) it insulates the lender from the effects of the bankruptcy of the borrower, and (d) it secures for the lender participation in the "upside" value of the operations financed, but only to the extent that production revenues from the burdened assets of the borrower exceed the borrower's costs of operations.[124]

A complete discussion of all of the legal issues raised by equity kicker transactions is beyond the scope of this paper. Nevertheless, we would be remiss if we did not at least mention the issue of usury. Usury concerns are of particular importance in equity kicker financings because, under Texas law, the equity interest received by the lender — whether in the form of an equity interest in the borrower or in the borrower's assets — may constitute a charge for the use, forbearance, or detention of money and, thus additional interest on the debt portion of the transaction under the Texas usury statute.[125]

There are a number of transaction structures that may be employed to address this issue, and all of them have been the subject of much judicial attention.[126] The most straight-forward manner of addressing the implications of Texas usury law in an equity kicker transaction, however, is to choose the law of another jurisdiction with fewer or no usury limitations (i.e., New York) to govern the credit portion of the transaction, or at least the issue of usury. Such a choice of law in Texas was greatly facilitated by the Texas Legislature's passage of Section 35.51 of the Texas Business and Commerce Code in 1993.[127]

Section §35.51 of the Texas Business and Commerce Code provides, among other things, that if the parties to a "qualified transaction" elect, in writing, that the law of a particular jurisdiction governs the enforceability of an agreement relating to the transaction or a provision

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[122] *See* Dunlap I, *supra* note 3, at 9, 10.

[123] *See id.*

[124] *Id.*

[125] *See* Dunlap I, *supra* note 3, at 24-28; Dunlap II, *supra* note 3, at B-11. For an excellent consideration of the usury considerations in an equity participation financing, *see* Weiner, *Usury Considerations in Equity Participation Loans*, STATE BAR OF TEXAS REAL ESTATE, PROBATE AND TRUST LAW SECTION NEWSLETTER (January 1985).

[126] *See* Dunlap II, *supra* note 3, at B-8 – B-11.

[127] *Id*. at B-13.

of the agreement, and the transaction "bears a reasonable relation" to that jurisdiction, then the law of the chosen jurisdiction governs, regardless of whether the application of that law is contrary to a fundamental or public policy of the State of Texas or any other jurisdiction.[128] Among transactions constituting "qualified transactions" for purposes of this statute is a transaction in which a party lends, advances, borrows, or receives, or is obligated to lend or advance or is entitled to borrow or receive, funds or credit with an aggregate value of at least $1,000,00.[129] A transaction "bears a reasonable relation" to a particular jurisdiction if (a) a party to the transaction is a resident of that jurisdiction, (b) a party to the transaction has its place of business or chief executive office, or an office from which it conducts a substantial part of the negotiations relating to the transaction, in that jurisdiction, (c) all or part of the subject matter of the transaction is located in that jurisdiction, (d) a party to the transaction is required to perform a substantial part of its obligations relating to the transaction (including delivering payments) in that jurisdiction, or (e) a substantial part of the negotiations relating to the transaction, and the signing of an agreement relating to the transaction by a party, occurred in that jurisdiction.[130] The legislature also added a subsection to then-Section 1.105 of the Texas Uniform Commercial Code providing that the provisions of Section 35.51 of the Texas Business and Commerce Code are applicable to contracts governed by the Uniform Commercial Code as adopted in Texas.[131] Section 1.105 of the Texas Uniform Commercial Code, as in effect when Section 35.51 was enacted, was eliminated from the Texas Uniform Commercial Code by the Texas Legislature's 2003 amendments thereto.[132]

The provisions of Section 35.51 of the Texas Business and Commerce Code offer significant flexibility in structuring an equity kicker transaction to avoid potentially adverse implications of Texas usury law. Note in particular that the parties to a "qualified transaction" are authorized to elect that the issue of usury alone, rather than the entire agreement governing the transaction, is to be governed by the laws of a state other than Texas.[133] Also, in most equity kicker transactions, one or more of the "reasonable relation" factors set forth in the statute will apply, or can be made to apply, to the transaction to support the choice of the law of a jurisdiction other than Texas to govern the issue of usury. A word of caution is appropriate, however, because as of this writing, no reported decision of a Texas court or a federal court applying Texas law has addressed this statute.

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[128] TEX. BUS. & COMM. CODE ANN. §35.51(b) (Vernon 2007).

[129] TEX. BUS. & COMM. CODE ANN. §35.51(a)(2)(B) (Vernon 2007).

[130] TEX. BUS. & COMM. CODE ANN. §35.51(d) (Vernon 2007).

[131] Prior this amendment, Section 1.105 of the Texas Uniform Commercial Code provided that the parties to a multi-jurisdictional transaction are free to choose the law governing their rights and duties under a contract subject to the Uniform Commercial Code as long as the jurisdiction chosen bears a reasonable relation to the multi-jurisdictional transaction. TEX. BUS. & COMM. CODE ANN. §1.105 (Texas UCC) (Vernon 1993). *See* Dunlap II, *supra* note 3, at B-12.

[132] Acts 2003, 78th Tex. Leg., ch. 542, §1.

[133] *See*, *generally*, Dunlap II, *supra* note 3, at B-12, B-13.

C. Trade and Vendor Financing

Another alternative source of capital for oil and gas producers may be found, under certain circumstances, with companies engaged in the oilfield service and supply sector of the oil and gas industry. Many industry veterans may recall the use of this type of finance during the decline of the oil and gas industry following the collapse of crude oil prices during the 1980s. At that time, many service companies, in order to stay in business, were willing to accept a working interest or some form of non-operating interest (frequently, a production payment) as payment for goods and services supplied. This type of financing was, at that time, a "last resort" for many services companies and producers.[134]

More recently, consolidation in the oilfield service and supply industries, coupled with intensified drilling activity driven by high commodity prices, have caused many service and supply companies to try to improve their competitive positions by offering financing to certain of their established, significant producer customers. These transactions can take any number of forms (including the production payment structure frequently used during the 1980's), but a transaction structure that has been used on occasion follows the model of the "equity kicker" transaction discussed in Section III.B of this paper – that is, a loan by the service provider or supplier to the producer (in almost all cases, the operator) secured by liens against the producer's interests in the oil and gas properties as to which the vendor supplies goods or services, with the vendor receiving an equity enhancement to its rate of return on the transaction by means of a net profits interest in production from the affected properties.[135]

IV. DOCUMENTING THE NET PROFITS INTEREST TRANSACTION

Regardless of the type of transaction, the current practice in documenting net profits interest transactions calls for the execution of two primary documents: (a) a net profits interest purchase and sale agreement (the "NPIPSA"); and (b) a conveyance of net profits overriding royalty interest (the "NPI Conveyance"). The remainder of this paper will discuss selected issues to be addressed in negotiating and drafting these documents.

A. Net Profits Interest Purchase and Sale Agreement

In the author's experience, the NPIPSA is a relatively short, straightforward agreement executed concurrently with the execution of the NPI Conveyance pursuant to which the net profits interest is actually granted. As such, the NPIPSA will customarily contain:

> (a) a provision providing for the conveyance of the net profits interest by the owner of the burdened lease (the "NPI Grantor") to the designated grantee (the "NPI Grantee") and, in a transaction other than a loan transaction, the payment of the agreed upon purchase price for the sale of the net profits interest;

[134] *See* Dunlap II, *supra* note 3, at B-1.

[135] *See* Dunlap II, *supra* note 3, at B-5, B-6.

(b) representations and warranties relating to the NPI Grantor and the burdened leases similar to those that would be found in a purchase and sale agreement for a sale of producing properties, including representations and warranties concerning (i) the organization, existence, and good standing of the NPI Grantor; (ii) the capacity and authority of the NPI Grantor to enter into the transaction; (iii) the enforceability of the NPIPSA, the NPI Conveyance, 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 NPI 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;

(c) provisions identifying the documents in addition to the NPI Conveyance executed in connection with the transaction, including officer's certificates, opinions of counsel, and similar matters;

(d) indemnities by the NPI Grantor relating to the breach of any covenant, or the breach of or inaccuracy in any representation or warranty, of the NPI Grantor contained in the NPIPSA or the NPI Conveyance; and

(e) provisions governing the transfer by the NPI Grantor of the burdened leases, the effect of the transfer on the net profits interest, and, if applicable, the method of valuing the net profits interest upon its disposition in conjunction with such a sale or transfer of the burdened leases.[136]

[136] *See, generally*¸ Muñoz , *supra* note 3, at 4, 9.

B. Conveyance of Net Profits Overriding Royalty Interest

The most significant document executed in connection with a net profits interest transaction is, of course, the NPI Conveyance that actually creates the net profits interest. In preparing an NPI 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 "net profits interest" in the oil and gas context has acquired a reasonably well understood meaning and character under applicable Texas jurisprudence,[137] it is clear from the discussion in Section II.B.3 of this paper that this is not the case in all of the oil and gas producing states.[138] In many cases, the courts in these states have looked closely at the language of the granting clause in the relevant NPI Conveyance to determine whether the document creates a mere contract right, or an interest in personalty, or a more familiar type of interest in oil and gas, such as an overriding royalty interest, that has a more well-defined meaning and character under the law of the particular state.[139]

For this reason, it is common practice for NPI Conveyances to be styled as "Conveyance of Net Profits Overriding Royalty Interest" and for the granting clause to convey an overriding royalty interest in production from the burdened lease(s) measured by a percentage of the net profits attributable to the burdened lease, rather simply conveying an interest in net profits.[140] Such a granting clause might read as follows:

> For and in consideration of TEN AND NO/100 DOLLARS ($10.00) cash and other good and valuable consideration in hand paid to WI Owner, the receipt and sufficiency of which are hereby acknowledged, WI Owner hereby GRANTS, BARGAINS, SELLS, CONVEYS, TRANSFERS, ASSIGNS, SETS OVER, AND DELIVERS unto Assignee, subject to the terms and conditions set forth hereinafter, a net profits overriding royalty interest (the "Net Profits Interest") in and to all Subject Hydrocarbons if, as, and when produced, saved, and marketed equal to the Net Profits Percentage of the Net Profits attributable to the Subject Interests.

2. Burdened Leases. In most net profits interest transactions, the net profits interest will burden multiple oil and gas leases located, many times, in several states. To the extent that the net profits interest is granted pursuant to a financing of drilling or other operations

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[137] *See* notes 29 through 43 and accompanying text, *supra*.

[138] *See* notes 44 through 58 and accompanying text, *supra*.

[139] *E.g.*, *compare Team Bank v. Meridian Oil Inc.*, 118 N.M. 147, 879 P.2d 779 (1994) (conveyance of a "net overriding royalty interest in Minerals in and under, and if, as and when produced, saved, and sold from, the Subject Lands … equal to … 75% of the Net Proceeds attributable to the Subject Interests" held to create an overriding royalty and an interest real property) to *Christy v. Petrol Resources Corp.*, 102 N.M. 58, 691 P.2d 59 (N.M. Ct. App. 1984) (interest in "net profits" was not interest in production and, therefore, was contractual in nature).

[140] *See* Hubert and Taylor, *supra* note 2, at 14-10.

for a specified group of wells, the net profits interest may cover only the wells for which the financing was provided. In other cases, the lender may insist that the net profits interest cover all of the borrower's oil and gas leases.[141] This approach can be beneficial to both the borrower/NPI Grantor and the lender/NPI 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 borrower's cash flow caused by the net profits interest and, at the same time, spreading the reserve risk and improving the likelihood of net profits distributions to the lender.[142]

a. Transfers of Less Than All of the Burdened Leases. The creation of a net profits interest covering multiple leases obviously complicates subsequent transfers of the NPI Grantor's interest in all or a portion of the burdened leases.[143] For this reason, it is important for either the NPIPSA or the NPI Conveyance to provide a mechanism for allocating and valuing the portion of the net profits interest burdening the leases to be sold, so that the NPI Grantee may be properly compensated if all or a portion of its net profits interest is sold in conjunction with the relevant leases. If the transferee of the leases does not also purchase the portion of the net profits interest burdening such leases, the NPIPSA or the NPI Conveyance should provide for the partition of the net profits interest into two separate and distinct net profits interests, one of which burdens the leases sold to the transferee and the other of which burdens the leases retained by the NPI Grantor.

b. "Alternative Source" Issues. Recall that one of the criteria that must be met for an interest in minerals to be characterized as a net profits interest is that the NPI Grantee must have no alternative source of payment with respect to the relevant interest other than income derived from the extraction and sale of minerals in place.[144] Net profits interests burdening multiple properties present alternative source issues as well as impermissible aggregation issues under Section 614 of the Code. Section 614(a) of the Code[145] treats each separate interest owned by a taxpayer in each mineral deposit in each separate tract or parcel of land as a separate "property" for purposes of the provisions of the Code dealing with the taxation of oil, gas and other mineral interests. Sections 614(b) and 614(e) of the Code[146] contain certain rules related to mandatory and elective aggregation of separate interests in the same or adjacent tracts or parcels of land. Under these rules, non-operating interests in the same or adjacent tracts or parcels of land may be aggregated with the permission of the Service. Non-operating interests in non-adjacent tracts or parcels of land may never be aggregated.

In *General Counsel Memorandum* 38,867, the Service initially took the position that an "aggregate" or "blanket" net profits interest burdening multiple Section 614 properties could not satisfy the economic interest requirement because amounts paid under the net profits interest

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[141] *See* Muñoz, *supra* note 3, at 15.

[142] *See* Dunlap I, *supra* note 3, at 13.

[143] *See* Sherrill, *supra* note 2, at 177-78.

[144] *See* notes 61 through 63 and accompanying text, *supra*.

[145] I.R.C. §614(a).

[146] I.R.C. §§614(b), 614(e).

could not be traced to any single property.[147] Less than six months later, in *General Counsel Memorandum* 38,907, the Service reversed its position, holding that a carved-out net profits interest burdening multiple Section 614 properties will be treated as a single economic interest if the burdened properties are economically interrelated.[148] An economic interrelationship exists if the amount owed to the holder of the net profits interest (i) may only be determined by taking into account the revenues and expenses from all of the burdened properties so that, in a given accounting period, the profit from one of the burdened properties may be offset by the costs from another, and (ii) the holder does not have a separate interest in any one of the burdened properties.

General Counsel Memorandum 38,907 was followed by Private Letter Ruling 83-12-019, holding that blanket net profits interests carved-out in connection with the formation of a royalty trust each constituted a single Section 614 property and an economic interest.[149] The Service subsequently refined its position regarding blanket net profits interests, holding that to constitute an economic interest, the blanket net profits interest must, in addition to burdening properties that are economically interrelated, be created and conveyed in a single conveyance. Thus, all of the burdened properties must be identified at the time of the conveyance, and properties may not be added to the blanket net profits interest after the date of its creation.[150]

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.[151] 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,[152] the Texas courts have not recognized any such duty on the part of the lease owner.[153]

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[147] May 27, 1982.

[148] October 14, 1982. *See also T.A.M.* 83-02-016 (October 5, 1982) (blanket production payment is a single economic interest); *G.C.M.* 38,216 (December 28, 1979) (same).

[149] December 15, 1982.

[150] *P.L.R.* 91-18-032 (February 6, 1991). *See also P.L.R.s* 91-27-024 (April 4, 1991), 91-27-027 (April 4, 1991), 91-27-028 (April 4, 1991) and 91-27-029 (April 4, 1991), *revoking P.L.R.s* 87-53-037 (October 6, 1987) (as supplemented by *P.L.R.* 88-04-077 (November 6, 1987)), 88-27-046 (April 12, 1988), 88-04-053 (November 3, 1987) and 88-28-023 (April 13, 1988). Retroactive relief provided in *P.L.R.s* 91-47-027 (August 22, 1991), 91-47-028(August 22, 1991), 91-47-029 (August 22, 1991) and 91-48-011 (August 22, 1991).

[151] *See* 2 H. WILLIAMS & C. MEYERS, *supra* note 1, §420.1 at 365.

[152] *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 (10th Cir. 1950) (same). *See* 2 H. WILLIAMS & C. MEYERS, *supra* note 1, §420.2 at 366.1, 366.2.

[153] *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 terminated; court refused to find a confidential relationship between the overriding royalty owner and the lessee).

For this reason, it is important that the NPI 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."[154] To maximize the applicability of the net profits interest, therefore, the NPI 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.[155]

3. Duration. The net profits interest must continue for the life of the burdened oil and gas lease. If the net profits interest terminates prior the expiration or termination of the burdened lease, the net profits interest will be treated, for tax purposes (and, in all likelihood, for state law purposes as well), as a production payment subject to the special characterization rules of Section 636 of the Code.[156]

4. Effective Date. In most net profits interest purchase and sale transactions, the net profits interest will be conveyed effective as of the date of execution of the NPI Conveyance or, perhaps, the first day of the month in which the NPI Conveyance is executed to facilitate the commencement of the accounting for the net profits interest.

Similarly, in most equity kicker transactions, the lender will attempt to require the borrower to convey the net profits interest to the lender on, and effective as of, the closing date for the loan. This arrangement will likely place significant strain on the borrower's cash flow since he will be required to satisfy his debt service and net profits interest obligations at the same time, thus increasing the chance of a default by the borrower while the lender is enjoying the enhancement to the return on its investment resulting from the net profits interest.[157]

For this reason, most borrowers will attempt to postpone the vesting of the net profits interest until after the loan is repaid. In accomplishing this result, the parties must keep mind the continued applicability of the rule against perpetuities in Texas. The Texas Constitution provides that "perpetuities…are contrary to the genius of a free government and shall never be allowed."[158] Because there is no statutory definition of the perpetuities prohibited by the Constitution, Texas courts have adopted the common law rule of perpetuities as controlling.[159] The Texas courts have defined a "perpetuity" as a limitation that takes the subject matter of the perpetuity out of commerce for a period greater than the life or lives in being and twenty-one

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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).

[154] *Id.*

[155] *See* Herbert and Taylor, *supra* note 2, at 14-30 – 14-32; Terrell, *supra* note 2, at 40-43.

[156] I.R.C. §636. *See* Treas. Reg. §1.636-3(a)(2).

[157] *See* Muñoz, *supra* note 3, at 14; Dunlap I, *supra* note 3, at 10.

[158] TEX. CONST. art. I, §26.

[159] *Mattern v. Herzog*, 367 S.W.2d 312 (Tex. 1963).

years thereafter, plus an ordinary period of gestation.[160] Accordingly, the courts have adopted the formulation of the rule against perpetuities first advanced by Professor Gray as follows: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the time of the creation of the interest," plus a period of gestation.[161]

The key element of the rule against perpetuities is the postponement of the vesting in interest of an estate beyond the period of the rule. An estate is vested in possession if the owner of the estate has the present right to use, occupy, and enjoy the property. This is not the type of vesting with which the rule against perpetuities is concerned. The rule against perpetuities is concerned solely with the vesting of estates in interest.[162] An estate is vested in interest if the owner of the estate is identifiable, and the vesting of the estate in possession is subject to no condition precedent other than the expiration of estates prior to it in possession.[163] A "vested interest" may be described as an interest clothed with a present, existing, and legal right of alienation.[164] The requirement of the rule against perpetuities is satisfied once an estate becomes vested in interest, regardless of when it becomes vested in possession.[165] After an estate has become vested, it is immaterial under the rule how long that estate may last.[166]

Against this background, there are several ways to approach this issue. First, the lender may agree to defer the execution of the NPI Conveyance until after the maturity date of the loan. This approach, of course, exposes the lender to the risk that an uncooperative borrower will delay or refuse to execute the NPI Conveyance at that time to try to extract concessions from the lender.[167] Second, the NPI Conveyance may be executed at the closing of the financing, but provide that the net profits interest will not become effective until repayment in full of the debt. If the maturity date of the debt is not stated or specifically incorporated by reference, this approach may well violate the rule against perpetuities. In that case, it will be necessary to include in the NPI Conveyance a perpetuities savings clause, which will provide that, notwithstanding any other term of the NPI Conveyance to the contrary, the net profits interest will be deemed to have become vested in interest in the borrower within the period of the rule.[168]

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[160] *Brooker v Brooker*, 130 Tex. 27, 106 S.W.2d 247, 254 (1936).

[161] J. GRAY, RULE AGAINST PERPETUITIES §201 (4TH ed. 1942). *See*, e.g., *Henderson v. Moore*, 144 Tex. 398, 190 S.W.2d 800 (1945); *Brooker v. Brooker*, 130 Tex. 27, 106 S.W.2d 247, 254 (1936).

[162] *Kelly v. Womack*, 153 Tex. 371, 268 S.W.2d 903, 905-6 (Tex. 1954).

[163] BERGIN & HASKELL, *Preface* to ESTATES IN LAND AND FUTURE INTERESTS Ch. 4, §4 at 118-120 (1966).

[164] *City of Houston v. West*, 563 S.W.2d 680, 684 (Tex. Civ. App. – Waco 1978, writ ref'd n.r.e.).

[165] *Kelly v. Womack*, 153 Tex. 371, 268 S.W.2d 903, 905-6 (1954); *Hunt v. Carroll*, 157 S.W.2d 429, 437 (Tex. Civ. App. – Beaumont 1941, writ dism'd by agr.).

[166] *Hunt v. Carroll*, 157 S.W.2d at 437.

[167] *See* Dunlap I, *supra* note 3, at 10-11.

[168] *See* Dunlap I, *supra* note 3, at 11. A typical perpetuities savings clause reads as follows:

> It is not the intent of Assignor or Assignee that any provision herein violate any applicable law regarding the rule against perpetuities, the suspension of the absolute power of alienation, or other rules regarding the vesting or duration of estates, and this

A third approach calls for the granting of the net profits interest on a present basis, but the deferral of the obligation to calculate and distribute net profits until the maturity date of the loan specified in the debt instrument of the borrower. In this case, the present vesting of the net profits interest, coupled with a specific date for the commencement of net profits calculations, should satisfy the requirements of the rule against perpetuities.[169]

5. Calculation of Net Profits. As has been discussed previously in this paper, neither state law nor federal income tax law defines or prescribes a formula for calculating the "net profits" payable to the owner of a net profits interest.[170] For that reason, it is imperative that the NPI Conveyance provide in detail the manner in which net profits will be calculated and the mechanics and timing of their distribution.

Most current net profits interest conveyances provide for the creation of a "Net Profits Account" to which charges and credits will be made on a monthly basis. Typically, "net profits" will exist with respect to any month when (i) the sum of (A) any credit balance existing in the Net Profits Account on the first day of the month, plus (B) the total credits properly made to the Net Profits Account during the month, exceed (ii) the sum of (A) any charge balance existing in the Net Profits Account on the first day of the month, plus (B) the total charges made to the Net Profits Account during the month. When net profits exist at the end of any month, the agreed upon percentage of the net profits will be payable to the NPI Grantee within a specified period (usually 60 or 90 days, to allow for the NPI Grantor's joint interest invoicing and production purchaser payment cycles to run their course for a production month) after the end of each production month, with past-due amounts bearing interest at a specified rate. If the aggregate charges exceed the aggregate credits to the Net Profits Account at the end of any month, the excess charges will be carried forward and taken into account in the calculation of Net Profits during succeeding months.[171]

Several variations of this approach to the calculation of net profits have received consideration in the federal income tax jurisprudence and appear to have passed muster with the Service and the courts.[172]

> Conveyance shall be construed as not violating such rule to the extent the same can be so construed consistent with the interest of the parties. In the event, however, that any provision hereof is determined to violate such rule, then such provision shall nevertheless be effective for the maximum period (but not longer than the maximum period) permitted by such rule that will result in no violation. To the extent such maximum period is permitted to be determined by reference to "lives in being," Assignor and Assignee agree that "lives in being" shall refer to the lifetime of the last to die of the now living lineal descendants of the late Joseph P. Kennedy (father of our late President, John F. Kennedy).

[169] *See* Dunlap I, *supra* note 3, at 11-12.

[170] *See* notes 11 through 13 and accompanying text, *supra*.

[171] *See* Terrell, *supra* note 2, at 10.

[172] *See, e.g.*, *Farwell v. Commissioner*, 35 T.C. 454 (1960); *Callahan Mining Corp. v. Commissioner*, 428 F.2d 721 (2nd Cir.), *cert. denied*, 400 U.S. 903 (1970); *United States v. Thomas*, 329 F. 2d 119 (9th Cir. 1964); *P.L.R.* 84-11-017 (December 7, 1983); *G.C.M.* 38,216 (December 28, 1979).

6. Credits to the Net Profits Account. If the characterization of a net profits interest as an economic interest in minerals in place and as a "royalty" within the meaning of Section 512(b)(2) of the Code is of importance to the parties to a net profits interest transaction, it is imperative that, in drafting the NPI Conveyance, the parties keep in mind that the owner of the net profits interest must look solely to the minerals in place for the return of its investment – that is, the NPI Grantee may have no possibility of sharing in income derived other than from the extraction and sale of the minerals in place.

In this regard, rights to share in the proceeds of the disposition of the surface estate, lease equipment, or the underlying mineral property are prohibited alternative sources of payment.[173] A working interest owner's option to prepay or call a production payment (and, presumably, other non-operating interests) is, in the opinion of the Service, an alternative source of payment,[174] as is a guaranty of payment by a party to the transaction who has no meaningful right of subrogation.[175]

For these reasons, it is important that the credits to the Net Profits Account be limited to revenues attributable to production from the burdened leases, including: (i) proceeds received by the NPI Grantor from the sale of such production: (ii) advance payments, prepayments, and other sums representing compensation to the NPI Grantor for oil and gas produced from the burdened leases prior to the time of actual production; (iii) recoupable take-or-pay payments at the time when the gas purchaser receives the recoupment gas; and (iv) amounts representing direct, actual damages received by the NPI Grantor in connection with a judgment in or settlement of a dispute related to the amount of the proceeds from the sale of production actually owned by the purchaser of production. There should be no credit to the Net Profits Account for items such as (i) proceeds from the sale of any of the burdened leases or any personal property or equipment located thereon; (ii) revenues received by the NPI Grantor from gas transportation, gathering, marketing, or, except as discussed below in this Section IV.B.6., processing; (iii) non-recoupable or unrecouped take-or-pay payments or non-recoupable amounts received by the NPI Grantor as a judgment in or settlement of a take-or-pay dispute;[176] (iv) dry hole payments, bottom hole

[173] *Anderson v. Helvering*, 310 U.S. 404 (1940) (surface estate); *Christie v. United States*, 436 F.2d 1216 (5th Cir. 1971) (equipment); *Gibson Products Co. v. United States,* 637 F.2d 1041 (5th Cir. 1981) (equipment and underlying leases); *Burke v. Commissioner*, 5 T.C. 1167 (1945) (underlying lease); *T.A.M.* 89-41-002 (June 16, 1989) (burdened property). *Cf., Standard Oil Company (Indiana) v. Commissioner,* 465 F.2d 246 (7th Cir. 1972) (contrary to prevailing view, a remote likelihood of payment from disposition of the burdened working interest may not violate the rule).

[174] P.L.R. 93-05-014 (November 10, 1992); P.L.R. 93-16-033 (January 26, 1993); P.L.R. 94-14-021 (January 6, 1994).

[175] *See*, *e.g*., *Holbrook v. Commissioner*, 54 T.C. 1617 (1970), *rev'd* 450 F.2d 134 (5th Cir. 1971).

[176] Please not that we have excluded from the credits to the Net Profits Account the amounts of any unrecouped or non-recoupable take-or-pay payments or any non-recoupable amounts received by the NPI Grantor in settlement of a take-or-pay dispute. The Texas courts have, as a general matter, characterized such amounts not as payments for gas production, but as damages received by the non-operating interest owner for gas that was not taken or paid for. *See, e.g., Lenape Resources Corp. v. Tennessee Gas Pipeline Co.,* 925 S.W.2d 565 (Tex. 1996); *Mandell v. Hammon Oil & Refining Co.,* 822 S.W.2d 153 (Tex. Civ. App. -- Houston [1st Dist.] 1991, writ denied); *Killam Oil Co. v. Bruni,* 806 S.W.2d 264 (Tex. App. -- San Antonio 1991, writ denied); *TransAmerican Natural Gas Corp. v. Finkelstein,* 933 S.W.2d 591 (Tex. App. -- San Antonio 1996, writ ref'd).

payments, or other payments received as consideration for deferring the drilling of a well, or as an adjustment for any well or leasehold equipment; (v) the proceeds of any loans to the NPI Grantor; (vi) revenues from the NPI Grantor's hedging[177] amounts received by the NPI Grantor as payment of direct or indirect overhead charges.

Determining how to value processed gas for purposes of calculating net profits requires special attention because of the treatment of processing in the "no alternative source" rules and jurisprudence. Section 613(a) of the Code limits a taxpayer's percentage depletion allowance to a specified percentage of the "gross income from the property."[178] Section 1.613-3 of the Treasury Regulations generally defines the term "gross income from the property," with respect to oil or gas wells, to mean the amount for which the oil or gas is sold in the immediate vicinity of the well or, if otherwise, the representative market or field price at the wellhead. Thus, revenues derived from transportation, refining, and manufacturing processes are not depletable income and the right to share therein will negate economic interest status. Simple gravity or mechanical separation in the vicinity of a well is a production process. Thus, natural gas sold in the vicinity of a well as it emerges from a separator, and the condensate recovered from the separator, constitute gross income from the property. Most other downstream revenues will not qualify as gross income from the property.

In Technical Advice Memorandum 1999-18-002, a corporation sold its interest in a foreign gas field to a related corporation for money and a retained net profits interest equal to a percentage of the net income from liquified natural gas ("LNG"). Because the LNG, when sold, had value added by the liquifaction process, it was argued that the retained interest was not an economic interest in the minerals in place. The instrument creating the net profits interest had a savings clause, however, which provided that payments thereunder could not exceed the "gross income from the property" attributable to the burdened properties. The Service ruled that the economic interest test was met because the instrument provided for payment of a variable portion of the "gross income from the property," up to 100 percent, and did not permit payment derived from post-production revenues.[179]

Against this background, there appear to be two possible approaches to valuing processed gas in the context of a net profits interest. Under the first approach, there would be credited to the Net Profits Account an amount representing the market value of the gas in its unprocessed state. This approach is consistent with the decisions of the Texas courts concerning whether royalty on processed gas should be paid by reference to the amounts received by the lessee for the products extracted from the gas and the residue gas after processing. In these cases, the Texas courts have consistently held that royalty is not owed on natural gas liquids extracted

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[177] Although there are no Texas cases directly in point, there is authority in other states that proceeds from hedging activities do not represent "the fruits of the lessee's production function" but reflect the entrepreneurial activities of the producer and, therefore, are not royalty-bearing under an oil and gas lease. *E.g., Candelaria Industries, Inc. v. Occidental Petroleum Corp.*, 662 F. Supp. 1002, 1005 (D. Nev. 1984) (net profits interest equal to 10% of gain from mining activities on the leased premises held to pertain only to minerals actually produced and not to lessee's profits from hedging transactions.) *See* Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 258 (1996); Terrell, *supra* note 2, at 10.

[178] I.R.C. §613(a).

[179] *Id.*

during processing in the absence of an express provision in the royalty clause obligating the lessee to do so, regardless of whether the gas is first sold to a third party and then processed[180] or processed by the lessee prior to sale.[181]

The foregoing approach, of course, is not tied to an objective standard and, therefore, increases the likelihood of accounting disputes about the correctness of the credits to the Net Profits Account with respect to the processed gas. For this reason, consideration should be given to a second approach under which there would be credited to the Net Profits Account an amount equal to the sum of the proceeds received by the NPI Grantor from the sale of the products extracted from the gas by processing and the residue gas after processing, less all costs of gathering, compression, transportation, and processing.

The effect of this "net back" calculation is to establish a value of the gas before processing when the sale of the gas does not occur until after processing. This approach to the valuation of processed gas has been adopted by the Fifth Circuit in a case involving sour gas produced from Mississippi oil and gas leases that required processing for the removal of sulphur before the gas could be sold.[182] When accompanied in the NPI Conveyance by a savings clause similar to the one considered by the Service in Technical Advice Memorandum 1999-18-002[183] (i.e., the cumulative net profits payable under the NPI Conveyance will never exceed 90% of the cumulative "gross income from the property" as defined in Section 613(a) of the Code), this approach should satisfy the requirements of the "no alternative source" rule and not adversely impact the characterization of the net profits interest as an economic interest in minerals in place.

7. Charges to the Net Profits Account. The costs changeable to the Net Profits Account ultimately will be determined by the negotiations of the parties. As a general matter, however, it is appropriate to use a "broad brush" when determining to the costs and expenses to be charged to the Net Profits Account. In a transaction involving a sale of a net profits interest, it is customary to see charges to the net Profits Account made for the following items, to the extent incurred after the effective date of the net profits interest and paid by the NPI Grantor: (i) costs of drilling and completion operations; (ii) costs of workovers and other remedial well servicing operations; (iii) costs of waterfloods, gas lift operations, and other enhanced recovery operations; (iv) operating expenses; (vi) production expenses; (viii) except to the extent taken into account in valuing processed gas for purposes of credits to the Net Profits Account, costs of processing, gathering, compression, dehydration, separation, treatment, transportation, and marketing production; (ix) direct overhead charges paid to lease operators by

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180 *Read v. Britain*, 414 S.W. 2d 483, 487 (Tex. Civ. App.-Amarillo 1967), *aff'd*, 422 S.W. 2d 902 (Tex. 1967); *Lone Star Gas Co. v. Harris*, 45 S.W. 2d 664, 667 (Tex. Civ. App. – Eastland 1931), *on reh'g*, 45 S.W. 2d 998 (Tex. Civ. App. – Eastland 1932, writ ref'd).

181 *E.q., Danciger Oil & Refineries, Inc. v. Hamill Drilling Co.,* 141 Tex. 153, 171 S.W. 2d 321 (1943); *Carter v. Exxon Corp.,* 842 S.W. 2d 393 (Tex. App. – Eastland 1992, writ denied).

182 *Piney Woods Country Life School v. Shell Oil Co.,* 726 F. 2d 225, 239 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005, 105 S. Ct. 1868 (1985). *Accord, see* Seddlemeyer, *Royalties on Processed Gas*, 36TH OIL AND GAS INST. 5-1, 5-16 (Matthew Bender 1985). The Texas Supreme Court has endorsed the use of the "net back" method of calculating market value at the well in a case involving unprocessed gas in *Heritage Resources, Inc. v. NationsBank, Co., Trustee*, 939 S.W. 2d 118 (Tex. 1996).

183 January 15, 1999.

the NPI Grantor; (x) lease maintenance payments; (xi) dry hole payments, bottom hole payments, and other payments by the NPI Grantor to third parties for deferring the drilling of a well or as an adjustment of well or leasehold equipment; (xii) ad valorem, production, severance, and similar taxes; (xiii) insurance premiums; and (xiv) the amounts of any damages, judgments, and losses suffered by the NPI Grantor with respect to the burdened leases.[184]

Again, although these items are subject to the negotiations of the parties, customarily, there will be no charge to the Net Profits Account for: (i) lease burdens or other amounts that have been deducted in determining the amount of production subject to the net profits interest or otherwise netted against credits to the Net Profits Account; (ii) the acquisition costs of the NPI Grantor with respect to the burdened leases; (iii) damages payable by the NPI Grantor in connection with breaches of the NPIPSA or the NPI Conveyances; (iv) amounts paid by the NPI Grantor for debt service; and (v) any losses or costs incurred by the NPI Grantor in connection with its hedging activities. The deductibility from the Net Profits Account of some or all of the general and administrative and overhead costs of the NPI Grantor is almost always an intensely negotiated issue in these transactions. In addition, in transactions involving the financing of drilling or other "capital" operations on the burdened leases, the lender/NPI Grantee may be expected to insist that the costs of the operations being financed, which will be repaid to the lender by means of the borrower's debt service on the loan, be excluded from the charges to the Net Profits Account.[185]

Please note that even though, as discussed above in Section IV.B.6 of this paper, certain revenues received by the NPI Grantor in the ordinary course of business are not properly chargeable to the Net Profits Interest Account because they do not qualify as proceeds from production, most of such amounts may be used as offsets against the charges to the Net Profits Account. Although these offsets have the effect of reducing the expenses deducted from the revenues used to calculate net profits, thereby increasing the available net profits, the amount of such offsets may never, by themselves, constitute net profits. Consequently, the use of such amounts as offsets in this manner should not run afoul of the "no-alternative source" rules.[186]

8. <u>No Liability for Costs of Operations</u>. Lack of liability for the costs of exploring, developing and operating the burdened leases in excess of production revenues is an essential requirement of all non-operating interests, including net profits interests.[187] It has been argued that this requirement is not met in the case of blanket net profits interests that aggregate profits and losses from multiple properties. That argument was rejected by the courts in *Callahan*

[184] *See* Shervill, *supra* note 2, at 197-199; Hubert and Taylor, *supra* note 2, at 14-19 - 14-22; Terrell, *supra* note 2, at 11-12

[185] *See* Muñoz, *supra* note 2, at 7.

[186] *Id*.

[187] Reg. §1.614-2(b); Reg. § 1.614-5(g); Rev. Rul. 69-179, 1969-1 C.B. 158.

Mining Corp. v. Commissioner[188] and *United States v. Thomas,*[189] and by the Service in *General Counsel Memorandum* 38,216.[190]

For this reason, each NPI Conveyance should provide that the NPI Grantee shall have no personal liability for costs and expenses charged against the Net Profits Account or for liabilities incurred in connection with the ownership, exploration, development, equipping and operation of the burdened properties and the production and marketing of the hydrocarbons produced therefrom, and should require the NPI Grantor to indemnify and hold harmless the NPI Grantee from and against all such costs, expenses, and liabilities.

V. CONCLUSION

There are, of course, numerous other issues that must be addressed in a net profits interest transaction – audit rights and arbitration of disputes; the obligations, if any, of the NPI Grantor to the NPI Grantee regarding operations on the burdened leases, the prevention of drainage, and related matters; the rights of the NPI Grantee upon the abandonment of a burdened lease by the NPI Grantor; and the effect on the net profits interest of farmouts, non-consent operations, and the formation of pooled units, to name a few. Hopefully, however, this discussion will provide a useful starting point for practitioners handling such a transaction.

[188] 428 F.2d 721 (2nd Cir. 1970), cert. denied, 400 U.S. 903 (1970).

[189] 329 F. 2d 119 (9th Cir. 1964).

[190] December 28, 1979. ("[W]e do not believe that the existence of a reserve account or the aggregation of profits and losses from several leases amounts to an indirect payment of development or operations costs so that the [NPI holder] should be treated as the owner of a working interest").