# **ARTICLE: Financial Aspects of Oil Transactions** [[1]](#footnote-2)\*

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**Text**

**[\*550] INTRODUCTION**

The financial aspects of ***oil*** transactions for the purpose of this discussion will be considered under two major categories, namely, the types of transactions utilized in financing or promoting drilling operations on unproven or wildcat properties, and the types of transactions utilized in financing drilling operations on proven or semi-proven properties. It is my intention to confine this discussion to the business and legal phases of ***oil*** transactions and to avoid tax considerations. We will not devote any time to considerations of the drilling and testing of wildcat properties or the development of proven properties held by producing ***oil*** companies for their own sole account. These activities are financed with their own earnings and present no problem to the average practicing attorney.

While I do not intend to discuss the tax consequences of this subject, I want to impress upon you with all sincerity at my command the importance of viewing this entire subject in the light of tax considerations and tax consequences. It would be very foolish to buy any of the programs we are going to discuss without ascertaining whether they fit your client's tax situation.

**TYPES OF TRANSACTIONS UTILIZED IN FINANCING DRILLING OPERATIONS ON UNPROVEN OR "WILDCAT" PROPERTIES**

*A. Assignment of Entire Lease Block for Cash Reserving Overriding Royalty*

1. *The Basic Situation*

Probably the most common form of ***oil*** transaction with respect to unproven acreage is an assignment of the entire lease block for a cash payment with the reservation to the assignor of an overriding royalty interest. This situation generally arises after an individual, or a group of individuals, or a company finds a prospective oilfield and obtains leases covering what appears to be the potential oilfield. The leases are then assigned to **[\*551]**a company or other individuals who undertake to drill a test well on the property within some specified period. In California, an overriding royalty over the base royalty usually is reserved to the assignor. This varies from one per cent to four and one-sixth per cent, the latter amount being the difference between one-eighth (12 1/2%) and one-sixth (16 2/3%).

2. *Some Pertinent Provisions*

Some of the pertinent provisions in such an assignment are as follows: The assignor imposes a drilling obligation on the assignee to drill a test well within a reasonable length of time and often to a specified depth or zone. In some instances the assignee is required to continue drilling operations periodically regardless of the rights of deferment under the lease, but generally he is required only to comply with lease obligations after the drilling of the initial test well. After discovery on the lease block, provision usually is made for subsequent development drilling either in accordance with the lease terms or at a more accelerated rate. Provisions in the assignment requiring the assignee to offset any wells drilled within a specified distance from the lease boundary are not uncommon.

Many times the assignor simply requires the assignee to comply with lease obligations, without realizing that the assignee may negotiate a modification of the lease with the lessor for the deferment of drilling, or for the elimination of offset requirements, or for other purposes which might not coincide with the best interest of the assignor. For this reason, it is advisable to spell out these obligations contractually for the benefit of the parties. It is wise to make provision for the protection of the overriding royalty interest in event of subsequent unitization of the leases in the field or in event the assignee works out a compensatory royalty arrangement with the lessor in lieu of drilling or producing certain wells on the particular lease. Protection against arbitrary action on the part of the assignee in modifying the lease or in joining a unit plan of operation may be incorporated in the assignment by requiring the assignor's consent to any modification of the lease which may alter any of the drilling or royalty provisions of the lease or the assignment. Usually the assignor will want to require the assignee to specifically assume and agree to perform the obligations of the lessee under the lease and will also wish to have the assignee indemnify and hold the assignor harmless from any liability or damages arising out of the assignee's failure to do so.

In many cases the assignor will wish to have the leases revert to him in event the assignee elects not to maintain the lease in effect by the payment of rental or by drilling. This can be covered by providing that the leases shall be returned to the assignor at least 30 or 60 or 90 days prior to the accrual of such obligation.

Restrictions against further assignment of the leases by the assignee **[\*552]**may be incorporated in the assignment as well as a provision specifically permitting the assignee to modify the lease or to extend the term of the lease. If this right is granted, care should be taken to spell out that such modifications shall not adversely affect the rights of the assignor under the instrument of assignment. Also, if this right of modification or extension is granted, consideration should be given to the effect on the assignor's rights in event of the extension of the lease term or in event the lease is terminated and a lieu lease is taken by the assignee. See *La Laguna Ranch Co. v. Dodge*, [[2]](#footnote-3)1which held that an overriding royalty interest carved out of the lessee's estate terminated upon a quitclaim or termination of the lease regardless of the fact that the overriding royalty owner did not join in the quitclaim. If this result is to be avoided, provision should be made that in event of extension of the lease or issuance of a lieu lease, the overriding royalty interest and other pertinent provisions of the assignment should continue in effect. This may be accomlished by a provision that the reserved overriding royalty and other obligations, conditions, etc., shall be applicable to any extension or lieu lease obtained by the assignee, or any subsequent assignee or sublessee. A practical solution to this problem may be made by incorporating a provision that the lease must be reassigned to the assignor at a specified date prior to the stated exploration date in the lease or prior to any quitclaim by the lessee. The assignee must then, of course, either reassign the lease to the assignor or obtain the assignor's consent to the extension or lieu lease, at which time the assignor can negotiate proper protection for his reserved interest. It should be remembered that all of these suggestions are entirely a matter of negotiation between the parties and whether or not the assignor can obtain all the benefits he desires will be determined by how desirable the lease is in the eyes of the assignee. There is no such thing as any standard provisions in agreements of this nature and each instrument must be tailored to fit the agreement of the parties. A title examination should be made prior to extending the lease term or securing a lieu lease, in order to ascertain whether any intervening liens may ripen at the end of the normal lease term.

3. *Assignment as Distinguished from Sublease*

Many of the provisions referred to above probably will make the instrument a sublease rather than an assignment, for it generally has been held that if the transfer is for a period less than a full term of the lease, or if the transfer reserves the right of entry, or if an overriding royalty, ***oil*** payment, or other economic interest is reserved, the transaction is a sublease and not an assignment. [[3]](#footnote-4)2Accordingly, care should be exercised **[\*553]**in drafting the document, having in mind the legal consequences of the relationship of sublessor and sublessee.

*B. Assignment of Entire Lease Block for Cash Reserving* ***Oil*** *Payment*

Another arrangement for promoting the drilling of a test well on a wildcat lease block is by assignment of an entire lease block for cash and an ***oil*** payment. This type of transaction has more limited application and generally is not common, inasmuch as the ***oil*** payment is a fixed sum and terminates upon the final payment of that sum, whereas the overriding royalty continues for the duration of the production. However, the ***oil*** payment is used in instances where the assignor has demanded a high cash bonus for the assignment of the leases and the parties have compromised on the payment of some portion of the bonus in cash and the remainder to be paid out of a specified percentage of production. The ***oil*** payment also may be reserved in an assignment of a portion of the working interest or in an assignment retaining a net profit interest, in order to insure to the assignor participation in the production prior to payout of drilling and operating costs.

*C. Checkerboard Assignment*

1. *Use of This Arrangement*

A standard transaction for promoting or financing the drilling of a test well on wildcat acreage, particularly in the mid-continent, is the assignment of some of the leases in a lease block or the assignment of all of the leases in the block as to a portion of the lands. This arrangement is referred to as a checkerboard farmout and may be made with or without reserving an overriding royalty as to the parcels transferred. This type of arrangement is best suited to a large lease block in areas where production is regulated by law, such as in Oklahoma, Texas, and New Mexico. This arrangement, generally speaking, is not well suited to California wildcat ***oil*** prospects, for in many instances California production is obtained from ***oil*** accumulations which underlie rather limited acreage but which are found in thick producing zones and of times in multiple producing zones. In Texas and New Mexico the producing zones generally are of limited thickness but are spread over a large area. This accounts for a customary spacing pattern in those areas of one well to each 40 acres, whereas in California greater density of development wells is more often the case.

The checkerboard farmout imposes an obligation on the assignee to drill a test well to a specific depth or zone on the assigned acreage at a location which will offset acreage retained by the assignor. In some instances the assignor may sell the checkerboard parcels for cash, with a condition that the payment by the assignee shall be due at such time as the assignor has drilled a test well on the assignor's retained acreage at **[\*554]**a location offsetting lands assigned to the assignee. Sometimes the assignment of the checkerboard acreage carries a reservation to the assignor of zones below or zones above a specified depth. There are some serious problems which arise with this type of arrangement which will be mentioned later. [[4]](#footnote-5)3

2. *Pertinent Provisions of Checkerboard Assignments*

Inasmuch as the parties generally hold acreage under identical leases, it may be advisable to provide that they shall perform lease drilling obligations in the alternate. That is, the assignee will drill a well on his parcel which will satisfy lease drilling obligations and the assignor will drill the next well required under that lease on his parcel, etc. It may be advisable also to provide for a spacing pattern in order to eliminate competitive line drilling on boundaries between the checkerboard parcels.

The parties should contemplate the consequences of a subsequent unitization or pooling arrangement of their parcels in event of discovery and, of course, provisions should be made for common rights-of-way for each party over and across the lands of the other.

3. *Advantages and Disadvantages*

Some of the advantages of a checkerboard arrangement are (a) the assignee drills, tests, and completes the test well without any cost to the assignor, but at a location which will prove or disprove the assignor's retained parcels or some of them; (b) each operator of the checkerboard parcels can regulate his operations, costs, drilling rates, production rates, etc., to best suit his individual financial and tax problems; and (c) each operator may sell or hypothecate his individual properties without consent or joinder of the other party.

Some of the disadvantages of the checkerboard arrangement include the hazards that the production may not be evenly distributed under the checkerboard parcels and one party may obtain considerably more than his pro rata share. Also, in the mid-continent areas, the fixed spacing pattern may not recover as much ultimate ***oil*** as an engineer-designed drainage pattern. The total cost of drilling and operating the properties probably is higher than in the case of joint operations because of duplication of gathering lines and tank setting.

*D. Assignment of Undivided Working Interest*

1. *Test Well as Consideration--Jointly or by Assignee Alone*

One of the more common methods of financing wildcat drilling is the assignment by the lessee of an undivided working interest in the entire lease block in consideration of the drilling of a test well by the assignee. **[\*555]**This situation certainly is fraught with tax consequences and should be treated gingerly by the general practitioner.

Such an arrangement may contemplate the assignment of an undivided working interest in consideration of a cash payment with provision for the drilling of a joint test well by the co-tenants, or it may involve no cash consideration but provide for the drilling of the test well at the sole cost and expense of the assignee for the joint account of the parties. This is often referred to as a "free" well or a "well to the sand." It should be pointed out here that such a well is not free in the sense that it represents a windfall to the assignor. More often than otherwise, the assignor has invested in the lease block, in geological, geophysical, land, and title costs, an amount equivalent to or in excess of the costs of drilling the test well to the objective horizon. This is particularly true in areas where the lease bonus is high and the test well relatively shallow. In some instances, the lease bonus, title costs, attorneys fees, etc., in town lot areas constitute ninety per cent of the total cost of the project, including the cost of drilling the test well. Accordingly, if the assignee earns an undivided one-half interest by drilling the test well at his sole cost, he has obtained a one-half interest in the lease block for ten per cent of the total cost of the project. The assignor usually joins in the cost of setting pipe and completing the well in the event the parties find sufficient encouragement to do so. Thereafter, all subsequent costs are shared in direct proportion to the co-tenants' respective working interests.

2. *Variations in Arrangements for Test Well*

There are many variations of this arrangement. For example, the parties may agree that the assignee is to bear the entire costs of drilling the test well to a specified depth or zone and thereafter further drilling costs in that well to a greater depth or deeper zone shall be shared by the parties in proportion to their interest. Or, the agreement may provide that if one party desires to continue drilling to a greater depth and the other does not, the eager party may do so at his sole cost but with the right of reimbursement out of production, if any, of a sum equivalent to 200% or some other agreed bonus percentage of such costs. In effect, this is a transfer of an ***oil*** payment to the drilling party.

An alternative to this arrangement may provide for the reduction of the working interest of the non-participating party as a bonus to the party conducting the deeper drilling.

Still another arrangement provides for the non-participating party to assign his entire working interest in the drill site to the drilling party, with or without an agreement to assign additional acreage outside the drill site as a bonus for drilling below the specified depth.

3. *Completed Well as Consideration*

In some cases the agreement will provide for the assignee to drill **[\*556]**and complete the well in order to earn his working interest, and this may or may not include the obligation to provide tanks. This may be at the sole cost of the assignee without the right of reimbursement or the assignee may be reimbursed out of production. If the assignor is to bear a portion of this cost out of production, the agreement may provide that the assignee is to retain all of the production prior to payout or is to recover the assignor's pro rata share thereof out of a portion of assignor's share of the production.

4. *Assignment Limited According to Depth*

On occasion, the assignment of an undivided working interest in the lease block is limited to the deepest zone or depth penetrated in the test well to be drilled by the assignee. In other words, the assignee earns his working interest in the leases only to the greatest depth penetrated by his test well, or in a subsequent well in the event that the first well is completed as a producer in a shallower zone or is abandoned for mechanical or other reasons. The assignee's right to perfect his working interest to deeper zones may be extended for a period of months or years if such is the agreement of the parties.

Usually, this type of agreement makes provision for the drilling and development by the assignor for his sole account of the zones below those in which the assignee has earned his working interest. Conversely, the assignment may be of an undivided working interest in zones *below* a specified depth or zone. This is usually the case where shallow production has been obtained prior to the farmout or where the assignor is unwilling to part with a working interest in the shallow zones but is desirous of making a sharing arrangement as to the deeper zones. Such an agreement may provide for the testing of the shallow zones reserved to the assignor in the test well being drilled by the assignee and usually safeguards are set up to protect the shallow zones against damage while being penetrated in search of a deeper zone. There are several pitfalls in this zonal arrangement. Often it is extremely difficult to identify a particular zone from samples or cores obtained in that zone. Usually, it is necessary to resort to the paleontologist to identify the zone or formation, and even then there may be some disagreement.

The danger involved in drilling or conveying interests to a specified depth is that the producing zone may extend above and below such footage depth. In one instance, the assignor conveyed all of its right, title, and interest in a certain lease to the depth of 6,000 feet retaining the lease as to ***oil***, gas, and casinghead gas below the depth of 6,000 feet. The 6,000 foot level passed through the productive sand and, accordingly, ***oil*** could be produced in that sand both above and below the 6,000 foot level. By order of the Corporation Commissioner of Oklahoma, the lease was included in a unitization plan. The assignee drilled a well to 6,000 feet, but not **[\*557]**beyond that point, and obtained production. The well was completed while the unitization proceedings were pending. The assignor had no well producing from this sand below the 6,000 foot level and was not authorized by the unitization plan to drill and produce therefrom. The Commission's order fixed the percentage of the authorized production that the assignor and assignee should receive and held that the order was applicable to the assignee's well. The assignee contended that the Commission had no authority to permit the assignor to share the production from its well. The Supreme Court of Oklahoma "held" that this contention was "predicated solely upon the assumption that the rule of capture obtains" and further that "the right of capture . . . does not obtain where by Act the State undertakes to protect the correlative rights of owners in a common source of supply," affirming the order of the Commission. [[5]](#footnote-6)4

A slightly different problem arose in *Carter* ***Oil*** *Company v. McCasland*. [[6]](#footnote-7)5The problem of unitization was not involved in this case. Here the assignor assigned to the assignee all of the assignor's right, title, and interest in and to certain leases insofar as these leases covered *producing horizons* above a depth of 4,000 feet. The assignee drilled a well and encountered theretofore undiscovered and unknown ***oil*** formation at a depth of less than 4,000 feet. Inasmuch as there was a high degree of dip in this formation it was encountered at a depth greater than 4,000 feet under a portion of the lease and above 4,000 feet under other portions. This issue arose when the assignor claimed the right to drill into the same zone in those areas where it would be encountered at a depth below 4,000 feet. The court concerned itself with the interpretation of the words "producing horizon" as used in the agreement and held that the rights to "producing horizons above the depth of 4,000 feet was descriptive of any horizons that might be encountered above that depth and therefore the assignee acquired the exclusive right to drill wells into all producing horizons found above 4,000 feet and with the exclusive right to produce therefrom all the recoverable ***oil*** and gas." It was held that the assignor was guilty of conversion to the extent that it had produced ***oil*** from that particular producing horizon even though produced below the depth of 4,000 feet.

An interesting situation might arise in a similar case if the assignee first drilled on that portion of the lease under which this particular horizon would be encountered below a depth of 4,000 feet, and if subsequent thereto and prior to the time the assignee encountered this producing horizon at a shallower depth the assignor drilled a well to such horizon and encountered it at a depth below 4,000 feet. One wonders if the court in this situation would hold that the assignee was not entitled to any production **[\*558]**from that zone even though it might be above 4,000 feet under certain portions of the lease.

*E. Assignment of Drill Site with Assignment of Undivided Working Interest in Balance of Lease Block*

Another sharing agreement which has received rather wide application in the mid-continent area, and to some extent more recently in California, is the assignment of a full leasehold interest in the drill site subject to a reserved overriding royalty or ***oil*** payment or net profit override, [[7]](#footnote-8)6together with a provision for assignment of an undivided working interest in the balance of the leaseblock. Such an arrangement usually provides for early test drilling on the drill site to a specified depth and provides for subsequent joint operations on the balance of the acreage under the normal joint working interest arrangements.

Such an agreement may require the assignee to continue drilling until production is found or until the assignee elects to reassign his interest to the assignor. In such a case, provision is made for the assignment of additional drill sites on which the assignee proposes to drill subsequent test wells. The assignee may or may not earn a vested interest in the drill sites depending upon the terms of the agreement. Conceivably, if the assignee continues drilling test wells and obtains drill sites in each case, he might eventually acquire the entire lease block. From a practical point of view, this seems extremely unlikely.

This type of farmout has certain advantages to the assignor: mainly, the entire cost of drilling, testing, and completing the test well is borne solely by the assignee, as is the cost of subsequent exploration prior to discovery and, in event of discovery, the advantages of the joint working interest arrangement become operative.

There are also certain advantages to the assignee, in that he retains 100% of the first production from the drill site subject only to the overriding royalty or ***oil*** payment or net profits interest and thus recoups his entire investment before the assignor participates. It is also possible that the assignee may be entitled to 100% of the intangible writeoffs which are incurred in the drilling of each such test well; however, this is a matter to be seriously considered by the tax counsel.

*F. Assignment Reserving Net Profit Override or Carried Interest*

Another popular farmout or sharing arrangement is the assignment of the entire leasehold interest in the lease block, reserving to the assignor a net profit override or carried interest. The net profit override has until recently enjoyed most of its popularity in California but is gradually receiving more favorable consideration in Texas and other mid-continent areas.

**[\*559]**The distinction between a net profit override and a carried interest is important primarily as to tax consequences, participation in salvage of physical equipment, and with respect to the rights of the assignor to convert to a working interest by reimbursing the assignee in cash for assignor's share of all accrued costs.

The essence of the net profit override or carried interest sharing arrangement is that the assignee bears and pays initially all costs incurred in drilling, development, and operation of the properties and recoups the assignor's share thereof out of production. The assignor normally does not share in any of the production until payout. However, in the case of the carried interest, some agreements provided that the assignor may accelerate his participation in production by reimbursing the assignee in cash for his share of accrued costs. The net profit override and carried interest are readily distinguishable from the ordinary overriding royalty which normally bears no share of any of the drilling or operating expense and is measured by the gross production in the same manner as the lessor's and landowner's royalty. Many instruments which create ordinary overriding royalty interests either by grant or reservation specify that the overriding royalty shall be computed in the same manner and shall be payable at the same time as the royalty payable to the lessor under the apposite lease.

Certain advantages are apparent in the net profit override arrangement. The assignor is not required to advance any part of the costs of drilling and operating the property, and after payout receives his share of the profits which enjoy depletion. The assignee is permitted to expense 100% of the intangibles and, of course, receives 100% of production until payout. His share of production is entitled to depletion also. There are some disadvantages to the assignor in that he actually pays for his proportionate share of all tangible equipment but acquires no interest therein and consequently has no share of the salvage thereof.

*G. Miscellaneous Methods of Financing Wildcat Drilling*

1. *Selling Overriding Royalties or Participating Units*

There are a number of miscellaneous methods of financing wildcat drilling which should be given attention. In some instances the leaseholder sells overriding royalties or participating units for cash to various individuals in order to finance part or all of the drilling costs for a test well. Or, perhaps, some of these costs are financed by assigning overriding royalties or participating units to drilling contractors for free or low cost drilling.

In some instances the entire operation, including the surveying of the drill site location, the grading of the drill site and roads, and all services connected with the drilling of the well are paid for by assignments of overriding royalties, participating units, or ***oil*** payments.

**[\*560]**Care should be exercised, particularly in California, to comply with all requirements of the pertinent provisions of the Corporate Securities Act which requires an authorizing permit from the Commissioner of Corporations prior to the sale or transfer of most, if not all, of the above-described interests.

2. *Bottom Hole Contributions*

Where proper conditions obtain, bottom hole contributions can be secured from neighboring leaseholders. This arrangement contemplates that the neighboring leaseholder will address a letter to the operator who proposes to drill the test well agreeing to make a cash contribution of a specified sum per foot for each foot of hole drilled in the test well down to a specified depth. Certain conditions are enumerated in the letter, such as the right to obtain all information developed during the drilling of the well, copies of all electric logs, dipmeter surveys, well logs, histories, drilling records, etc. Usually, the test well must be located within offset distance to the land of the neighbor who is contributing the bottom hole money. Bottom hole money is payable regardless of whether the operator obtains production or abandons the well as a dry hole.

3. *Dry Hole Contributions*

A slightly different and more popular form of contribution is the so-called dry hole contribution whereby the neighbor agrees to contribute a specified sum of money per foot but only in event the well is abandoned as a dry hole or non-commercial producer within a specified period of time. Otherwise, the provisions of the two contribution letters are similar. The bottom hole and dry hole contributions are made in order to induce the contributee to drill a test well at a location near the contributor's land which will, it is hoped, evaluate the contributor's land for ***oil*** and gas possibilities. Thus, the several neighbors in the area share the risk of the test well and share in the information developed therefrom.

4. *Limited Partnership Agreements*

In recent years the limited partnership arrangement has received favorable consideration by the ***oil*** operators and the uninformed investors. Under this arrangement the promoter usually is the general partner and the investors are the limited partners, although the promoter may be a limited partner also. A fixed sum is agreed upon for an exploration fund and usually the partners participate in more than one wildcat play. This arrangement may cover participation in a particular geographic area such as ***Kern*** County, or Louisiana, or the Permian Basin of West Texas; and, accordingly, any leases acquired in this area are obligated to the partnership for test drilling. Or, the partnership agreement may provide that the partnership is to participate in all areas regardless of location during a fixed period of time or until the fund agreed upon is exhausted. The agreement may provide for options to renew the arrangement from **[\*561]**time to time. The limited partners recover their investment before the general partner participates in any profits. After return of capital, the general partner usually receives a substantial interest in the profits.

It is possible, of course, to work out an arrangement whereby a group of individuals who wish to participate in ***oil*** exploration team together and appoint or designate a common agent to carry out the operations for them. This arrangement can be set up so that the individuals are relieved of routine matters concerning which they have little or no knowledge and the operating agent can proceed with full authority. Such an arrangement must be carefully documented in order to avoid the possibility of being taxed as an association and to avoid unwanted liabilities, but if properly drafted, a very satisfactory arrangement can be consummated.

*H. Merger of OH Exploratory Company with Ordinary Income-Producing Company*

Finally, and on a particularly large scale, we come to the financing of the exploration drilling by merger of an ***oil*** exploratory corporation with another corporation engaged in an unlike business, such as airplane manufacturing, which has considerable ordinary income subject to corporate tax. By proper consolidation, having in mind the tax benefits accruing from depletion allowances, intangible writeoffs, etc., the net income of the manufacturing company may be maintained and a sizable exploration fund generated for use by the ***oil*** company. These benefits result from the opportunity of the merged companies to file consolidated tax returns. This is also true, of course, where one of the corporations is a wholly-owned subsidiary.

**TYPES OF TRANSACTIONS UTILIZED IN FINANCING DRILLING OPERATIONS ON PROVEN OR SEMI-PROVEN PROPERTIES**

*A. Borrowed Funds*

Financing of proven or semi-proven ***oil*** properties is not a new problem. An individual or small company fortunate enough to discover an oilfield may find that it has a bear by the tail. Lease obligations require continuous drilling at stated intervals, and if the discovery is made near the end of the lease term it may be necessary to employ several strings of tools in order to validate one or more leases immediately. This can and usually does involve considerable costs. Inasmuch as the operator has only one producing well, the discovery well, and because it is almost impossible at this stage of development to evaluate ***oil*** reserves, it is difficult to secure an ordinary bank loan to finance subsequent drilling. Under these circumstances the operator is either forced to sell a portion of his leasehold interest for cash or in consideration of his assignee assuming some of his drilling obligations, usually with an overriding royalty, ***oil*** payment, or other interest reserved to the assignor; or he may induce the drilling contractor and the suppliers to extend him credit **[\*562]**and seek payment out of future production in the form of an ***oil*** payment. After several producing wells have been completed on the new oilfield, the operator will be in a position to arrange a bank loan based on the security established by the several wells. These loans generally provide for periodic repayment gauged by the production from the wells but with a minimum periodic payment regardless of well production.

If the discoverer is a major or major independent ***oil*** company with considerable assets, it may elect to issue bonds, or convertible notes, or preferred stock in order to raise working capital to take care of its development program. Long term financing on a large scale has become quite common to the ***oil*** industry and particularly with respect to the activities of the major ***oil*** companies in construction of refineries, pipe lines, and other facilities. It is interesting to note the trend of financing since 1933 as shown in the following statistical information:

*Long-Term Debt of 30* ***Oil*** *Companies*[[8]](#footnote-9)7

|  |  |  | **Public** |  |
| --- | --- | --- | --- | --- |
|  |  | **Insurance** | **and** |  |
| **December 31** | **Banks** | **Companies** | **Others** | **Total** |
| (Million Dollars) |  |  |  |  |
| 1933 | 1 | 0 | 870 | 871 |
| 1934 | 19 | 26 | 732 | 767 |
| 1939 | 48 | 202 | 775 | 1,025 |
| 1944 | 145 | 153 | 734 | 1,032 |
| 1949 | 802 | 934 | 868 | 2,604 |
| 1954 | 554 | 1,148 | 1,556 | 3,258 |

Twenty years ago loans based on ***oil*** properties were limited to relatively short term loans. As the ***oil*** business attained more stability, the term of production loans gradually increased until today ten year and longer loans are not unusual.

*B. Sale of* ***Oil*** *Payment*

The most common form of financing drilling operations on proven or semi-proven property today is the sale of an ***oil*** payment for cash. This arrangement can be made by selling future production to an individual or company who is interested in securing the return of his investment, plus interest, in a depletable commodity, or it may be arranged through a bank loan and a third party. The procedure in this case is for the ***oil*** company to make arrangements with the bank as to the amount of funds needed and to reach an agreement as to the amount of production to be allocated to the ***oil*** payment. For example, the bank agrees to loan $ 500,000 and the operator agrees to commit to the repayment of that **[\*563]**amount 50% of the production from the property in question. This is handled through a third party to whom the ***oil*** payment is actually assigned. This third party secures a loan from the bank on his personnal note, secured by the ***oil*** payment and usually by some personally-owned asset having a value equivalent to 20% of the loan. The third party adds a small amount of interest for acting as the intermediary. This arrangement is made with a third party because normally banks are not authorized to purchase ***oil*** payments but are authorized, of course, to make loans upon proper security. The operator, undoubtedly, could borrow the same funds from the bank and secure his note with a mortgage or trust deed on the properties, but this has a distinct tax disadvantage in many cases in that the operator must pay income tax on the taxable income from his production and repay the bank loan with income after taxes. When the ***oil*** payment funds are pledged to development of the property, the operator has no taxable income. [[9]](#footnote-10)8When the funds so received from the sale of an ***oil*** payment are not pledged to development of the property from which the ***oil*** payment is carved, the Government takes the position that the consideration received by the seller is for the assignment to the purchaser of expected production income for a fixed or limited period of time and is ordinary income to the seller subject to depletion. [[10]](#footnote-11)9Court decisions are contrary to the Government's contention and hold that the transfer result in capital gain. [[11]](#footnote-12)10Here again the tax counsel should be freely consulted in light of the taxpayer-operator's particular situation. The ***oil*** payment also may be transferred as consideration for drilling or furnishing of equipment on the same property. In either case, the operator is in a position to finance development drilling.

We may conclude that the financial aspects of ***oil*** transactions range from the poor-boy activities of the one man enterprise, who acquires a lease for nothing with a promise to try and find someone to drill a test well and thereafter conveys interests in the lease to bring about the testing of the property, to major long-term financing through loans, bonds, or preferred stock issues, Certainly, there is ample room within these two extremes for imagination and ingenuity in negotiating and drafting proper agreements for the testing, drilling, development, and operation of ***oil*** and gas properties.

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1. \* \* This article is based upon the author's syllabus and speech as part of the Continuing Education of the Bar's program on "Legal Aspects of the Oil and Gas Industry" held in Los Angeles on December 2 and 3, 1955. The Review wishes to acknowledge its gratitude to the Continuing Education of the Bar for its permission to use these materials. [↑](#footnote-ref-2)
2. 1 18 Cal.2d 132, n114 P.2d 351 (1951). [↑](#footnote-ref-3)
3. 2 Hartman Ranch Co. v. Associated ***Oil*** Co., 10 Cal.2d 232, 73 P.2d 1163 (1937); Garner v. Knudsen, 129 Cal. App.2d 747, 277 P.2d 890 (1953). [↑](#footnote-ref-4)
4. 3 See page 556 *infra*, Assignment Limited According to Depth. [↑](#footnote-ref-5)
5. 4 Palmer ***Oil*** Corp. v. Phillips Petroleum Co., 204 Okla. 543, 231 P.2d 997 (1951). [↑](#footnote-ref-6)
6. 5 190 F.2d 887 (10th Cir. 1951). [↑](#footnote-ref-7)
7. 6 See page 559 *infra* for definition of a "net profit override." [↑](#footnote-ref-8)
8. 7 TERRY, PETROLEUM FINANCING (Chase National Bank 1955). [↑](#footnote-ref-9)
9. 8 G.C.M. 22, 730, 1941-1 CUM. BULL. 214; Trans California ***Oil*** Co., 37 B.T.A. 119 (1938) ; Rawco, Inc., Ltd., 37 B.T.A. 128 (1938). [↑](#footnote-ref-10)
10. 9 G.C.M. 24849, 1946-1 CUM. BULL. 66; I.T. 4003, 1950-1 CUM. BULL. 10. [↑](#footnote-ref-11)
11. 10 Caldwell v. Campbell, 218 F.2d 567 (5th Cir. 1955). *Cf.* Commissioner v. Hawn, 56-1 U.S. TC P 9400 (5th Cir. 1956). [↑](#footnote-ref-12)