PRODUCTION PAYMENTS IN THE UNITED KINGDOM

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I. INTRODUCTION

Since the pioneering days of Drake,[1] the world has looked to the United States as a leader in most aspects of oil exploration and production, including the techniques of oil financing. The main reason for this, in the case of the United Kingdom, was its late arrival in the ranks of the oil producing countries, as there was no significant discovery of oil or gas within the jurisdiction of the United Kingdom until 1966, and the first project financing for the Forties field[2] was in 1972. By this time the banks, the oil industry and the legal profession in the United States had long since evolved effective financing methods and so it is hardly surprising that United Kingdom banks should have turned first to that body of experience.

In the event, the financing of the Forties field took the form of a forward purchase[3] of oil rather than a production payment.[4] However, the forward purchase was derived from the production payment and sought to incorporate as closely as possible the commercial terms of the latter. It owes its existence to the supposition that the production payment cannot be transplanted from the American soil in which it first took root to the harsher, or at any rate less adaptable, legal climate in

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1. Col. Edwin Drake is credited with drilling the first producing oil well in Pennsylvania in 1859.

2. *See* T. DAINTITH & G. WILLOUGHBY, A MANUAL OF UNITED KINGDOM OIL AND GAS LAW 14 (1977 and Supp. 1981) [hereinafter cited as DAINTITH & WILLOUGHBY].

3. The forward purchase is essentially a loan clothed as a trading transaction. Funds are provided to the oil company by way of advance purchase of oil, the oil being delivered in the years following the commencement of production in quantities sufficient to discharge the purchase price and accrued interest. *See* text accompanying note 10, *infra*.

4. The production payment may take the form either of a grant or of a reservation out of a larger interest in minerals of a right to receive a portion of any of such minerals as may be extracted, or of the proceeds of sale of such minerals, for a term which is limited not in time, as in the case of a lease, but by reference to the economic benefits received by the grantee. Where a lump sum is paid for the grant, the production payment is normally expressed to terminate when the value received by the grantee under it equals the purchase price together with interest thereon at an agreed rate. DAINTITH & WILLOUGHBY, *supra* note 2, at 40 (*citing* Walker, *Oil Payments*, 20 TEX. L. REV. 259 (1942)). *See also* Section II, *infra*.

the United Kingdom. The argument has been expressed in the following terms:

> It is clear that in the case of a production payment some language of assignment has to be used giving rise to the vesting in the grantee of a right to share in recovered oil . . . . Against the U.K. legal background, the only language of assignment which a producer could really use would be to assign an interest in the proceeds of sale of any oil which might be recovered and become owned by the grantor. Such language could not give rise to any property interest, even less any recordable property interest, such as U.S. banks are accustomed to obtain in the U.S.A. Under English law such language would be construed as an agreement and as giving rise to a contractual right to receive money and it would not stand up against a liquidation except in the sense of giving rise to a money claim in the liquidation.[5]

The reason which has been proferred for the differing conclusions of the United States and United Kingdom jurisdictions is that the grantor of a production payment in the United States is the owner of the oil *in situ* and can assign an ownership interest in it, whereas a United Kingdom licensee has no such title and cannot therefore convey one.[6] The principal purpose of this article is to suggest that this reason is unsound and that production payments can flourish in the United Kingdom, even if they take a slightly different form from the American strain.

As a preliminary, it may first be necessary to explain why it matters whether production payments can be used as a means for raising project finance in the United Kingdom, especially if there exists in the forward purchase an effective means of achieving the same end. The principal objective of the production payment, now that the United States tax advantages have been largely removed,[7] is to provide "off-balance sheet" financing.[8] In addition, if the financing can be brought

5. Marriage, *North Sea Petroleum Project Financing in the United Kingdom*, 5 INT'L BUS. LAW 207, 216-17 (1977).

6. The Crown issues the license and either has qualified ownership to possess and exclude others from possessing the oil or only has jurisdiction and control over it so that the oil remains *res nullius*. If the latter, then the Crown cannot license away title it does not have. If the former, the extensive controls retained by the Minister indicate the license is a purely contractual (bare) license, giving no more than a contractual right to explore and get the oil. DAINTITH & WILLOUGHBY, *supra* note 2, at 27-28; *see* text accompanying notes 30-42, *infra*.

7. I.R.C. § 636.

8. The technical effect of "off-balance sheet" financing is to avoid reflecting the transaction as a borrowing, or liability on the corporate balance sheet. Instead, financing of this variety might appear as "advance proceeds of oil" with a footnote on the financial statement. *See* Marriage, *supra* note 5, at 220-23. This is not the place to question either the practice or its effectiveness in these days of sophisticated analysis and of detailed reporting require-

within the definition of a production payment it may not be taken into account in calculating borrowing restrictions in debt instruments. Although a forward purchase may be "off-balance sheet," it is unlikely to assist in the latter objective since it does not meet the accepted definition of a production payment,[9] whatever the similarity of its commercial effect. More importantly, in the United States the purchase price would be treated for tax purposes as income in the year of receipt,[10] which makes the forward purchase unattractive for borrowers; in the United Kingdom taxable profits are generally calculated in accordance with normal accounting practices, which would not take the purchase price into the profit and loss account until the year in which the corresponding quantity of oil is delivered.

Accepting from this brief explanation that there is a present and continuing demand by U.S. companies operating in the North Sea for production payments, we turn to the question whether in fact they are precluded by English law in general or its licensing regime in particular.[11]

II. THE PRODUCTION PAYMENT IN THE UNITED STATES

Before attempting to analyze the nature and effect of a production payment in the United Kingdom, it would be as well to summarize our understanding of its nature and effect in the United States. Turning first to the *locus classicus* on the subject, Professor Walker's article *Oil Payments*, we read that a production payment is:

> a promise by the owner of the working interest under an oil and gas lease to deliver a fractional interest of the production of any or all of the minerals covered by the lease to the payee, or to pay him the monetary value thereof, until the payee has realized a certain sum from such deliveries or payments.[12]

The question is: what characteristics at law are to be attributed to such a transaction? Professor Walker himself traces the legal evolution

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ments; it is enough to accept that many oil companies consider the benefits to justify the cost of providing them.

9. *See generally* DAINTITH & WILLOUGHBY, *supra* note 2, at 40-41 (noted in 1981 Supp.).

10. I.R.C. § 451.

11. It should be made clear that we are concerned only with the effectiveness of a production payment under the law. In particular, the requirements for governmental consents under the terms of the production license and the tax consequences of making a production payment are beyond the scope of this article. In practice, the Inland Revenue (analogous to the Internal Revenue Service in the United States) is prepared to treat a production payment as a loan for tax purposes whatever its true nature, if so requested by the parties to the transaction.

12. Walker, *supra* note 4, at 262.

of the production payment in Texas, from *Dashko v. Friedman*,[13] where a royalty on production "as, if and when produced" was held to create only an interest in personalty after the minerals had been produced, to *Tennant v. Dunn*,[14] where a production payment was held to convey a present interest in land and did not merely evidence a debt payable out of production. Even in Texas, where the surface owner, including for this purpose a lessee, has title to oil in the ground, the interest of the grantee under a production payment falls short of an ownership interest in oil and gas in place.[15]

In other jurisdictions the treatment of a production payment seems to have varied. In New York, for instance, it was said that except for taxation purposes all rights under an oil and gas lease are personal property.[16] In Kansas, the authorities appear to conflict and the most that can be said of an oil lease is that it "affects" land.[17]

From our reading of the United States commentaries, it does not seem to follow that those states which recognize an oil lease as an interest in land must necessarily treat a production payment as such an interest. Nor do we understand that it is an inevitable requirement of a production payment that it should constitute an interest in land, still less that it should constitute a conveyance of oil and gas in place. To some extent this begs the question of the context in which the issue arises.

The cases in the United States have been concerned with a variety of purposes, from liability for registration fees, to the appropriate procedure for recording mortgages. These are local issues and are not relevant in a United Kingdom context which has its own separate machinery for such matters. In other cases however, the issue is more fundamental; it is the question whether, formalities of recordation apart, there has been conveyed to the grantee of the production payment sufficient interest in property to defeat claims by creditors of the grantor to the oil or gas in question. As Schmidt has put it:

> a court might . . . hold that the production created either (a) mere contractual rights against [the grantor], leaving [the grantee] without protection against subsequent secured creditors; or (b) a security interest in the working interest of [the grantor], necessitating real property foreclosure procedures in

13. 59 S.W.2d 203 (Tex. Civ. App.—Texarkana 1933, no writ).

14. 130 Tex. 285, 110 S.W.2d 53 (1937).

15. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923).

16. Vagts, *The Impact of the Uniform Commercial Code on the Oil and Gas Mortgage*, 43 TEX. L. REV. 825, 837 (1965).

17. National Bank v. Warren, 177 Kan. 281, 279 P.2d 262 (1955).

case of default.[18]

These are issues of universal relevance, as important in the United Kingdom as in any state of the Union. As a bare contractual right it would not, as Marriage points out in the passage quoted above,[19] overreach a liquidator or a secured creditor. As security for a loan it would presumably fail to achieve the objective of the transaction, whether it be "off-balance sheet" treatment or the avoidance of borrowing restrictions.[20] In this article we consider whether a production payment in the United Kingdom can be so framed and interpreted as to avoid both the alternatives postulated by Schmidt.

III. THE LICENSE INTEREST IN THE UNITED KINGDOM[21]

Whatever the uncertainties in state laws on oil and gas interests (and the articles cited in the preceding section suggest they are many) they pale against the uncertainties in English law. There are two reasons in particular for this. First, it is only in the last few years that an oil province of any size has been discovered within the United Kingdom jurisdiction, so that as yet there is no case law of direct relevance. Secondly, the bulk of the newly found oil and gas lies offshore in the continental shelf surrounding the United Kingdom. This has grafted considerations of public international law onto questions of municipal law, a process further complicated by the hesitant approach of Parliament to the problems of jurisdiction.

Originally it cannot be doubted that the surface owner in England had title to oil and gas beneath his land, on the principle of *cujus est solum ejus est usque ad coelum et ad inferos*.[22] Indeed, in denying the law of capture, English law apparently went further even than Texas in the defense of proprietary rights. In *Trinidad Asphalt Co. v. Ambard*,[23] the Privy Council upheld the Chief Justice of Trinidad and Tobago's dismissal of the relevance of the long line of Victorian cases on perco-

18. Schmidt, *Security Aspects of the ABC Transaction*, 65 MICH. L. REV. 1206, 1211 (1967).

19. Marriage, *supra* note 5, at 216-17.

20. As security for a loan the production payment would also be registrable as a charge under the Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 95, and, if not so registered it would be void against a liquidator or other creditor of the grantor.

21. It is not always appreciated that the United Kingdom comprises three separate jurisdictions, England and Wales, Scotland, and Northern Ireland, although most of the legislation enacted by Parliament is applied equally to all three. The authors are qualified only under English law, whereas most of the major offshore fields lie in Scottish areas. However, most, if not all production payments to date in the North Sea have been governed by English law.

22. "To whomsoever the soil belongs, he owns also to the sky and the depths." *See also* BLACKS LAW DICTIONARY 341 (5th ed. 1979).

23. [1899] A.C. 594 (Trinidad and Tobago).

lating water with the comment "asphaltum is a mineral not water." Accordingly, minerals under the surface formed part of the land. Even when the freeholder granted rights over the minerals, the rights granted were likely to be interests in realty. A mineral lease was itself an estate in land and *a profit à prendre* (a license to enter on the land and work the minerals) came within the statutory definition of "land"[24] as an incorporeal hereditament.

In 1918, the United Kingdom government prohibited oil exploration except on license from the government, although it did nothing to disturb proprietary rights. In 1934, however, all onshore oil and gas was vested (without compensation) in the Crown.[25] Licenses of all kinds have presented problems of classification under English law and the particular legislation relating to petroleum licenses has aggravated the difficulty. At one end of the spectrum a license may confer no more than a bare contractual right; at the other, when coupled with an interest, it may, as we have said, constitute an interest in land. There can be no doubt that licenses granted prior to 1934 were regulatory in purpose and no more proprietary in character than a dog or liquor license. However, since 1934 the grantor of the licenses has also been the owner of the petroleum itself, and this consideration opens the argument that with the change in the status of the grantor the nature of the license granted also changed, so as to become an interest in land as an incorporeal hereditament.[26]

However, this does not necessarily determine the nature of the licensee's interest, even in the case of an onshore license. Most licenses are held by a plurality of licensees operating as a consortium of joint venturers, and normally with unequal shares. Under English law this gives rise to a tenancy in common which, in the case of land, can only subsist as an equitable interest, a trust for sale being imposed on the legal interest, albeit subject to an automatic power of postponement.[27] Under the equitable doctrine of conversion, that which ought to be done is treated as having been done, and accordingly (notwithstanding the power which the trustees have to postpone sale) the interest of a single tenant in common is generally deemed to be an interest only in the proceeds of sale.[28] In such cases, even if the license grants an inter-

24. Law of Property Act, 1925, 15 & 16 Geo. 5, c. 20, § 205.

25. Petroleum (Production) Act, 1934, 24 & 25 Geo. 5, c. 36, § 1.

26. As applied to oil and gas law, an incoporeal hereditament, or a profit à prendre, is a right to search for oil and gas underlying the surface estate, as distinguished from the ownership-in-place concept which recognizes the existence of a fee ownership interest of the minerals in place. R. HEMINGWAY, LAW OF OIL AND GAS 11 (1971).

27. Law of Property Act, 1925, 15 & 16 Geo. 5, c. 20, §§ 34-36.

28. In re Price, [1928] Ch. 579.

est in land the licensee's interest becomes an interest in personalty. There are, however, sufficient exceptions to the rule to leave it uncertain how an interest in a production license would be treated.[29]

These considerations apply equally in the case of offshore petroleum licenses, with the problems of international law as an additional factor. Article two of the Convention on the Continental Shelf adopted at the United Nations Conference on the Law of the Sea provides that "the coastal state exercises over the continental shelf sovereign rights for the purpose of exploring it and exploiting its natural resources."[30] The Convention was incorporated into the municipal law of the United Kingdom by the Continental Shelf Act, 1964, which vested in the Crown "any rights exercisable by the United Kingdom outside territorial waters . . . with respect to the sea bed and subsoil and their natural resources."[31] Different views have been expressed in the United Kingdom on whether the Convention confers any proprietary interest in oil and gas in the continental shelf. On the one hand, it is said that the powers of the Crown are only regulatory and until extraction the oil is *res nullius*.[32] If so, the Crown can have no proprietary interest in it nor, obviously, any licensee from the Crown.

The contrary view is that the Crown's exclusive privilege of exploration and exploitation, while falling short of ownership, is proprietary in nature.[33] This, it is submitted, is more consistent with the 1964 Act[34] and the legislative regime of which it forms part. Both the contractual form of the licenses and the absence of any express prohibition on unlicensed activity import *dominium* and not simply *imperium*.[35]

At the least, this would mean that the Crown is capable of passing a proprietary interest to a licensee. It does not necessarily follow that such a license, or an undivided interest therein, is in fact proprietary in nature. To determine this question we must first ascertain by which law it is to be decided.

The continental shelf outside territorial waters is not part of the

29. An interest under a trust for sale has been held to be an interest in land for the purposes of limitation of actions under the Real Property Limitation Acts and for the purposes of Law of Property Act, 1925, 15 & 16 Geo. 5, c. 20, § 40 (requiring an agreement for the disposition of an interest in land to be evidenced in writing).

30. Convention on the Continental Shelf, art. 2, *opened for signature* Sept. 29, 1958, *in force* June 10, 1964, 15 U.S.T. 473, T.I.A.S. No. 5578 (adopted at the First United Nations Conference on the Law of the Sea in Geneva, 1958) [hereinafter cited as Convention]; *see* DAINTITH & WILLOUGHBY, *supra* note 2, at 167-83.

31. Continental Shelf Act, 1964, c. 29, § 1.

32. Marriage, *supra* note 5.

33. DAINTITH & WILLOUGHBY, *supra* note 2, at 21.

34. Continental Shelf Act, 1964, c. 29, § 1.

35. DAINTITH & WILLOUGHBY, *supra* note 2, at 21.

United Kingdom, but the Continental Shelf Act, 1964[36] has followed the Convention[37] in allowing the government to exercise jurisdiction over its continental shelf. The difficulty arises from the manner in which jurisdiction has been extended. The Continental Shelf (Jurisdiction) Order, 1968[38] applies English law in areas adjacent to England and Scots law in areas adjacent to Scotland for the determination of questions "arising out of acts or omissions"[39] in connection with the exploration of the sea bed or subsoil or the exploitation of their natural resources. It is an unresolved question whether the reference to acts or omissions is, as the phraseology might suggest, confined to torts, or whether it is intended to apply to the law generally, including the law of property, notwithstanding that questions may arise which do not turn on acts or omissions. In arguing for the latter interpretation it can be pointed out that the law does not conveniently separate into watertight compartments, and some torts, *e.g.*, trespass, may be difficult to determine without reference to the law of property.

There is one further comment to make on the license interest under English law. When dealing with the undivided interest of one of several co-licensees, it is misleading to speak only of an interest in the license. The license itself confers a right, jointly in the case of a plurality of licensees, to "search for, bore and get, petroleum"[40] subject to numerous regulations and controls. The license does not itself regulate either the percentage interests of the separate licensees or their rights generally *inter se*. This is left to the usual operating agreement, which in turn may spawn ancillary nomination and lifting agreements, and pipeline and terminal agreements. A recent decision of the Special Commissioners of the Inland Revenue[41] has held that, for purposes of capital gains tax, the licensee's asset is not just the license (as the Inland Revenue contended) but its "undivided interest in the consortium arrangements taken as a whole."[42]

IV. THE ESSENTIALS OF A PRODUCTION PAYMENT

In view of the problems referred to in the last section, the most that can be said with assurance is that a holder of an undivided interest

36. Continental Shelf Act, 1964, c. 29, § 1.
37. Convention, *supra* note 30.
38. Continental Shelf (Jurisdiction) Order, 1980, STAT. INST. 1980, No. 184, *reprinted in* DAINTITH & WILLOUGHBY, *supra* note 2, at 395-400.
39. *Id.* para. 3.
40. The Petroleum (Production) Regulations, 1976, STAT. INST. No. 1129, Sched. 5, para. 2; DAINTITH & WILLOUGHBY, *supra* note 2, at 432.
41. Decision of the Special Commissioners of the Inland Revenue (*unreported* 1980).
42. *Id.*

in a United Kingdom offshore license may have an interest in land. It could only be an incorporeal interest and would fall short of an ownership interest. However, we have noted above that even in those states, such as Texas, which represent the high water mark of ownership rights, it seems that the production payment does not convey an ownership interest in the oil and gas in place.[43] In other states, such as New York, even the lessor of mineral rights has an interest in personalty only and not in realty.[44]

From this it may be asked whether the possession of an interest in land is an essential requirement of a production payment. We have quoted above a definition of a production payment by Professor Walker which is directed more to its commercial effects than its nature in law.[45] Professor Walker also suggests that the production payment is an overriding royalty of limited duration[46] but, as Schmidt points out, this analogy begs rather than answers the question of its legal nature.[47] Other definitions stress requirements such as freedom from the obligation to meet operating costs, absence of a right to work the lease, and the exclusion of payment from any source other than the extracted petroleum.[48] But these are consequences, rather than elements, of the production payment and do not indicate its fundamental nature.

It seems to us that the elements which are fundamental are those which distinguish the production payment from all other transactions. Schmidt envisages that a court might treat a production payment as either a bare contractual claim or as security for a loan, with the disadvantageous consequences we have noted.[49] If it is neither of these, the production payment must constitute a purchase of a present property right, the purchase negating a loan and the property right constituting a right *in rem* as opposed to a money claim *in personam* against the grantor. Under this analysis there would not appear to be any need for the property right to be an interest in land, although it seems from the cases in the United States that for practical reasons relating to the recordation ("registration" in United Kingdom terminology) of interests in land, it may help if it is.[50]

43. Stephens County v. Midland Oil & Gas Co., 130 Tex. 285, 110 S.W.2d 53 (1937).
44. Vagts, *supra* note 15.
45. Walker, *supra* note 4, at 262.
46. *Id.* at 269.
47. Schmidt, *supra* note 17, at 1208 n.9.
48. *Id.* at 1208; Walker, *supra* note 4, at 260.
49. Schmidt, *supra* note 17.
50. *Id.* at 1214 n.35.

V. THE PRODUCTION PAYMENT UNDER ENGLISH LAW

That English law will give effect to a production payment—even if it is not a transaction recognized by that name—is not in doubt. If the language is clear enough to yield a meaning, the parties capable of making binding obligations, and the transaction is not vitiated for lack of consideration or other reason of public policy, such as illegality, a production payment will have at least contractual force. So much is accepted by the argument cited at the beginning of this paper.[51] The crucial question is, therefore, not, will English law give effect to a production payment, but what effect will it give? In particular, will it treat it as a conveyance of property rights so as to avoid the alternatives postulated by Schmidt?[52]

Suppose that a document in a form familiar in the United States as a production payment were made subject to English law, and contained a grant clause as follows:

> The grantor hereby grants, assigns, transfers, and delivers to the grantee the following:
> (a) an undivided [ ] per cent in all petroleum accruing [within a stated period] until the production payment is fully discharged; and
> (b) all right interest and title of the grantor under all contracts for sale of the petroleum to receive payment therefor until the production payment is fully discharged.

The effect of that grant may be shortly stated as the right to receive petroleum or its sale proceeds, from the source which is the subject of the grant, until the value of the petroleum or the amount of its proceeds reaches a stated amount. If that is a correct analysis and if it is accepted that the licensee has no property right in the petroleum itself as it lies in the sea bed, the property rights which he has are those derived from the license and the operating agreement. It would follow that any property right which is to be transferred by a production payment must be similarly derived from these contracts.

However, before one can conclude that such property rights can form the basis for a satisfactory security, we must first consider another question: Is it likely that the English courts would look through a document framed as a production payment and decide that as it was in commercial reality a loan, it should be given a similar legal effect? We think not. There is no doctrine of English law that two transactions having similar commercial results are the same in law. Nor, with two

51. *See* text accompanying note 5, *supra*.
52. Schmidt, *supra* note 17.

exceptions, will courts decline to give literal effect to written contracts.[53] If there is some consideration of public policy involved the courts have traditionally sought to implement the public purpose, and this has sometimes led them to prefer substance to form. An example of this approach is the treatment of the Bills of Sale Acts.[54] A Bill of Sale being a document intended to transfer the ownership of goods without possession, the Victorian Acts[55] regulating their form and use had as their purposes the prevention of false credit being given to people allowed to remain in possession of their goods. More important, the Acts helped to prevent the indigent from being trapped into signing complex documents which they did not understand.[56] In deciding whether instruments are within the scope of the Acts, the courts have consistently considered the substance of the transaction, and sought to establish whether the documents conceal the true nature of the transaction.[57]

The second exception, which is perhaps no more than an extension by degree of the first, is that if a document is a sham the courts disregard its form and look to the parties' true intentions. "Sham" has been judicially defined to mean:

> acts done or documents executed by the parties . . . which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create.[58]

That is a description of an extreme case, and one bordering on fraud. The rare quality of a true sham was well illustrated by the *Yorkshire Wagon* case.[59] There a railway company wished to raise money on the security of its wagons. It resolved to do so by a simple loan, but the directors were then advised that its constitution did not empower it to borrow. Counsel advised that the same commercial result could be achieved by selling the rolling stock and taking a lease back. So the

53. This bias towards literalism is going through a phase of being unfashionable. *See e.g.*, LORD DENNING, THE DISCIPLINE OF THE LAW, ch. 2 (1979); but the critics have not shaken the traditional view, and the Courts remain less than divine (*Cf.* I *Samuel* 16:7).

54. Bills of Sale Act, 1878, 41 & 42 Vict., c. 31; Bills of Sale Act (1878) Amendment Act, 1882, 45 & 46 Vict., c. 43; Bills of Sale Act, 1890, 53 & 54 Vict., c. 53; Bills of Sale Act, 1891, 54 & 55 Vict., c. 35.

55. *Id.*

56. Manchester, Sheffield and Lincolnshire Ry. Co. v. North Central Wagon Co. (1888) 13 App. Cas. 554, 560. *See* Bills of Sales Act (1878) Amendment Act, 1882, 45 & 46 Vict., c. 43; 4 HALSBURY'S LAW OF ENGLAND, para. 606 (4th ed. 1973).

57. In re Watson, (1890) 25 Q.B.D. 27. *See e.g.*, 4 HALSBURY'S LAW OF ENGLAND, paras. 661-63 (4th ed. 1973).

58. Snook v. London & West Riding Investments, Ltd., [1967] 2 Q.B. 786, 802.

59. [1882] 21 Ch. D. 309.

resolution was amended by pen, and the transaction proceeded in the form of sale and lease, on a basis not dissimilar to the old United States practice of financing railroad rolling stock by leasing and the issue of equipment trust certificates.[60] The rentals were guaranteed and the guarantors resisted a claim against them on the grounds that the transaction was *ulta vires*. The claim against the guarantors was upheld by the Court of Appeal, which declined to give the contractual documents anything other than the most literal construction.[61]

Taking the view that a production payment would not be treated as a secured loan by another name, we can now return to consider whether a production payment would be regarded in English law as a transfer of property. Although the question is completely untested and novel, we are inclined to think that it would. Our view is that effect be given to the production payment as an assignment of the grantor's rights to petroleum derived from the license and the operating agreement. Being expressed as a grant or transfer of rights, the court would, in our view, be disposed towards a construction consistent with that. It would on this basis be viewed as an assignment of contractual rights, which are a species of chose in action, and well-recognized as capable of forming the subject matter of an effective assignment, both at law and in equity.[62] As we have mentioned, the grantor's interest in the operating agreement is as a tenant in common in equity, and his interest is capable of subsisting only as an equitable interest.[63] This is the interest, comprising as it does the right as against the other co-licensees to lift an agreed share of production, which forms the essential subject-matter of the assignment. It is the same interest which entitles the licensee/grantor to the proceeds of sale of petroleum which he has lifted. In passing, we make the point that the subject-matter of the assignment comprises only some of the grantor's contractual rights. The grantor does not wish to concede, nor would the lenders wish to assume, the operating rights and obligations. However, there is no reason under English law why this should alter the position; a chose in action (in ordinary parlance, a right to sue) is no less such a right when it covers only some of a bundle of contractual rights, rather than the whole.[64]

Under the rule governing the priority of successive dispositions,

60. *See e.g.*, Tomkinson v. First Pennsylvania Banking & Trust Co., [1961] A.C. 1007, 1009.

61. Yorkshire Ry. Wagon Co. v. Maclure, [1882] 21 Ch. D. 309, 319.

62. Fitzroy v. Cave, [1905] 2 K.B. 364; Law of Property Act, 1925, 14 Geo. 5, c. 20, § 136.

63. *See* text accompanying notes 3-6, *supra*.

64. *See generally*, BLACK'S LAW DICTIONARY 219 (5th ed. 1979).

usually known as the rule in *Dearle v. Hall*,[65] that assignee who first gives notice to the debtor or trustee has priority, provided he has no actual or constructive notice of an earlier assignment at the date of his own. If A is indebted to B, and B assigns the debt successively to X and Y, then Y is entitled to priority over X if he is the first to give notice to A, *and* he has no knowledge of the earlier assignment to X at the date of his assignment.

Translating this to the context of a production payment, the grantee's rights will prevail over those of any other person claiming to be an assignee or mortgagee if (i) he is the first to notify the other parties to the license and the operating agreement and (ii) he had no knowledge at the date when the production payment was executed of any such other assignment or mortgage. Neither of these requirements should cause any difficulty in practice since notice will be given immediately, and it is inconceivable that a production payment would be executed if the grantee had any knowledge of other claimants.

Nor would it prejudice the grantee's rights if, as will normally happen, the grantor contracts to sell the petroleum to buyers who are unaware of the grantee's rights. The grantee's interest attaches to the proceeds of the sale, and if the document is well-drawn, arrangements will be included to ensure that the proceeds pass immediately into the control of the grantee.

Two points must, however, be made here. First, the rights of the assignee, or grantee, are subject to any rights which the other co-licensees have against the grantor. This is because the assignee cannot be in a better position than his assignor; but there is a practical point involved as well. It will often be provided in the default clause of an operating agreement that the rights of the non-defaulters are to have priority over third party claimants, the commercial justification being that it is the non-defaulters who will have to make good the default. Secondly, and also dependent on the maxim that no one can give more than he has, the grantee's rights will subsist only for as long as the license subsists and the grantor retains his share under the operating agreement. If this goes, by reason of default or otherwise, the grantee's rights go also. As we understand it, this does not differ in substance from the position in the United States where the termination of the oil lease automatically brings to an end the production payment which was carved out of it.[66]

On the other hand, if we are right in thinking that in English law a

65. [1828] 3 Russ. 1, 38 Eng. Rep. 475.
66. *See* Walker, *supra* note 4.

production payment would have the effect of assigning the grantor's contractual rights, the assignment should remain inviolable notwithstanding the grantor's liquidation or insolvency—assuming that the grantor is an English company. It could only be impeached if the production payment was entered into within six months of the commencement of the winding up, and if it would be liable to be treated as a fraudulent preference for the purposes of the bankruptcy law; that is, a dealing by the grantor at a time when he could not pay his debts as they fell due, and made with the dominant motive of preferring one creditor over the others.[67] It is hardly likely that a production payment would be signed in these circumstances.

However cogent or otherwise the arguments we advance for the effectiveness of a production payment we must accept that they are less persuasive to lenders than a definitive statement of the law would be. As we have mentioned, there is no case law directly on point. Nevertheless, it is possible to meet the risk that a production payment will not be effective as such in English law by securing the operating and other obligations of the grantor (including the obligation to deliver oil or the proceeds of sale thereof) with a charge on such interest as the grantor has in the license and related operating agreements, limiting enforcement to the proceeds of oil produced.[68] If the production payment is held to be ineffective as such, then, whether it is treated as a bare promise or as security for a loan, the security will bite on the entirety of the grantor's interest in the license and operating agreements and will secure the whole of the grantor's obligation. Therefore it should protect the grantee as fully as was intended by the production payment. If, however, the production payment is effective, the security will only bite on the residual interest of the grantor after the production payment has been carved out, but at the same time there should be less need for security. The grantor's objectives will also have been achieved in practice, notwithstanding the giving of security. Production payments in which the authors have been involved have been accepted as such by lawyers in the United States for purposes of avoiding debt restrictions in indentures, and by the auditors of United States companies in reporting on their balance sheet treatment. Practical support of this kind

67. Companies Act, 1948, 11 & 12 Geo. 6, c. 72, § 320.

68. The distinction between English and Scots law is most apparent when it comes to securing license interests. For a more detailed explanation of the problems *see* Cameron, *Security in Scotland*, International Bar Association Energy Law Seminar (1979) and Willoughby, *Legal Problems in Financing North Sea Oil with Special Reference to Problems of Creating Security*, Conference on North Sea Oil and the Law, Worcester College, Oxford (1975). Copies of these papers are on file with the HOUSTON JOURNAL OF INTERNATIONAL LAW.

for the arguments made in this article goes further than meeting the needs of the grantor. It does much to reassure lenders in the absence of direct judicial authority. Perhaps this is as well since, given the amounts nowadays at stake in the development of an offshore field, no lender will wish to see his financing put to the test.