

Michigan Law Review

Volume 65 | Issue 6

1967

Security Aspects of the ABC Transaction

John T. Schmidt

University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Bankruptcy Law Commons](#), [Oil, Gas, and Mineral Law Commons](#), [Property Law and Real Estate Commons](#), [State and Local Government Law Commons](#), and the [Taxation-Federal Commons](#)

Recommended Citation

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

Available at: <https://repository.law.umich.edu/mlr/vol65/iss6/5>

This Response or Comment is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

Security Aspects of the ABC Transaction

In recent years, investments in subterranean oil and gas have become a common addition to the investment portfolios of national financial institutions. Relying on the assurances of reputable geological studies, traditionally conservative financiers have invested amounts ranging up to several hundred million dollars against collateral once accepted only by speculators and a few adventurous oil-country bankers. The increased interest in these investments is in part attributable to the development of the ABC method of financing the purchase of producing oil and gas properties.¹ This method offers unique tax advantages, which have been discussed elsewhere,² but also creates problems for the financier who must weigh the possibility that he will have to defend his collateral in the courts. The purpose of this Comment is to examine both the nature of the collateral acquired by the investor in the ABC transaction and the legal protection which such collateral is likely to be afforded.

I. THE NATURE OF THE INTEREST ACQUIRED BY THE INVESTOR

The basic function of the ABC transaction is to transfer producing oil and gas properties from seller (A) to buyer (B).³ Absent tax

1. See 2 WILLIAMS & MEYERS, OIL AND GAS LAW 368 (1959) [hereinafter cited as WILLIAMS & MEYERS]; Appleman, *The ABC Deal*, S.W. LEGAL FOUNDATION, 11TH INST. ON OIL & GAS TAX 519 (1960); Oberwetter, *The Sale and Purchase of Producing Properties*, 9TH ROCKY MT. MINERAL L. INST. 403 (1964). Since the tax advantages of the ABC transaction are available, although to a lesser degree, in transactions involving any depletable natural resource, it has been used to finance the purchase of other mineral properties and even standing timber. Cf. Rowen, *Taxation of Income From Timber Properties*, 33 TAXES 336 (1955). The largest ABC transaction to date was the \$460 million financing of the purchase of the coal properties of Consolidation Coal Company by Continental Oil Company. Nevertheless, the ABC method is most commonly used in the petroleum industry. Since the security problems posed by the non-petroleum ABC are not significantly different from those involved in the oil and gas transactions, the scope of this comment will be limited to the latter.

2. See, e.g., Rowen, *The ABC Transaction From the Viewpoint of the Purchaser of the Working Interest*, N.Y.U. 21ST INST. ON FED. TAX 957 (1963); Sack, *ABC's of the ABC Oil Transaction*, 59 NW. U.L. REV. 591 (1964); Spencer & Rowen, *Acquisition of Oil and Gas Properties Through the ABC Transaction*, P-H OIL & GAS TAXES 2211 (1965). A proposed amendment to INT. REV. CODE OF 1954, § 1012, recently introduced by Senator Gore, would require that B capitalize the costs of production attributable to oil accruing to the production payment. S. 3719, 89th Cong., 2d Sess. (1966). The passage of this bill would eliminate much of the tax benefit enjoyed by the ABC transaction and may perhaps spell the demise of this method of financing.

3. The large number of these transactions which have occurred in the past decade is an outgrowth of economic conditions in the petroleum industry since World War II. Typically, A holds working interests in a number of developed petroleum deposits with substantial proved reserves. Conservation laws restricting production from the properties, imported oil, and generally depressed oil prices have limited the rate at which the value of A's properties can be realized. If A has alternative investment opportunities from which he anticipates a higher rate of return, he will wish to liquidate his interest in the developed petroleum properties. In most instances, B is a marketing, distributing, or refining company seeking assured future sources of crude oil or natural gas.

considerations, the basic transaction could be accomplished through merger, consolidation, or outright purchase. The acquisition could be financed by retained earnings, the sale of stocks or bonds, or a conventional commercial loan secured by the general credit of B or a mortgage against the purchased properties. Were the transaction to assume any of these forms, there would be no special problems of security law presented.

If, however, the parties wish to achieve the desired tax advantages, a third party (C) finances a major portion of the purchase price.⁴ But, in contrast to traditional methods of financing, C must forego status as a creditor or shareholder of B. Thus, in the ABC transaction, A conveys the properties to B but reserves an undivided interest in the properties free of the costs of production. This interest—a production payment—is then sold to C for an amount representing a major portion of the total purchase price. C's investment plus an amount representing interest on the unpaid balance is liquidated out of subsequent production from the purchased properties.⁵ By the terms of the production payment reservation, C is a co-owner of the purchased properties during the liquidation period, although he does not have the right to control their operation. B is obligated to maintain production from the properties so long as is economically practicable, but he does not become indebted for the amount invested by C, since C, as a production payment owner, agrees to look solely to the production from the properties for the return of his investment.⁶ Where C has borrowed the purchase price of the production payment, C's lender will receive C's note secured by a mortgage against the production payment—generally C's prin-

4. In most instances, C is a corporate shell serving as a vehicle for a commercial lender. C borrows the funds used to purchase the production payment and realizes as its profit the difference between the interest it receives and that paid. C may also be a pension trust, university, or charitable foundation seeking an investment opportunity for its funds.

5. It is this aspect of the ABC transaction from which its tax advantages over conventional methods of financing arise. The proceeds of the petroleum accruing to the production payment are not income to B, but rather are taxable to C as depletable income. *Thomas v. Perkins*, 301 U.S. 655 (1937). C will be able to offset against this income a cost depletion deduction which will leave only the interest increment taxable to C. The production payment is frequently designed so as to leave B with only enough income from the purchased properties to cover the deductible costs of production. Thus, during the life of the production payment, there will be a minimum of taxable income resulting to B from the purchased properties.

Since the tax benefits of the ABC transaction arise out of the relationship between percentage and cost depletion, the method of financing is attractive in the purchase of properties producing any depletable natural resource. Because the percentage depletion is largest in petroleum, the tax advantages of the financing method are maximized in the petroleum ABC.

6. In order to preserve the desired tax consequences, B's covenants to maintain production may not amount to a guarantee of the payout of the production payment. See *Anderson v. Helvering*, 310 U.S. 404 (1940).

cipal asset.⁷ Thus, the security of the financier's position, whether that of purchaser or lender, depends to a large extent on the legal nature of the interest created by the production payment.

A. *The Single Property Production Payment*

The single property production payment, long utilized in oil and gas transactions, is an undivided interest in an oil and gas lease, severed from the right to produce petroleum from the property (the working interest) and free of the costs of bringing the petroleum to the surface.⁸ Thus, the production payment, like a royalty interest, entitles the owner to a specified percentage of the production from the subject matter of the lease, free of the costs of production.⁹ Moreover, the production payment is similar to other interests created out of a leasehold insofar as it is destroyed by the termination of the underlying lease.¹⁰ However, the distinctive feature of the production payment is that it will terminate during the life of the lease if and when the cumulative value of the petroleum accruing to the production payment reaches a specified amount. In addition, the percentage of production dedicated to the production payment is usually higher than that accruing to a royalty interest which will continue for the entire life of the lease. The single property production payment thus offers important flexibility in financing the development and operation of an oil and gas lease, by making available a speculative interest which will pay out relatively early if the operation is successful, but which also shares the risk of a dry hole.¹¹

B. *The ABC Production Payment*

In form, the multiple property ABC production payment is a refinement of the single property production payment, although it differs from its predecessor in several respects. First, the speculative nature of the interest is reduced since the ABC production payment is created primarily out of developed properties with proved reserves. The initial concern of any petroleum financier is the amount of oil and gas which can be recovered from a given property. Despite increased geological sophistication, unpredictable natural causes exist which can slow or halt production from a single well or an entire field. Nevertheless, these risks are substantially less with respect to developed properties than those which face a wildcat

7. See note 4 *supra*.

8. Walker, *Oil Payments*, 20 TEXAS L. REV. 259 (1942).

9. It has been suggested that the production payment is, in fact, a limited duration overriding royalty. Walker, *supra* note 8, at 269. However, since this analogy begs, rather than answers, the questions raised herein, it will not be pursued further.

10. *Collins v. Atlantic Oil Producing Co.*, 74 F.2d 122 (5th Cir. 1934); *Tunstill v. Gulf Prod. Co.*, 79 S.W.2d 657 (Tex. Civ. App. 1934).

11. 2 WILLIAMS & MEYERS 367.

driller sinking a well on a previously undeveloped lease, since geologists are now able to predict with a high degree of accuracy the future potential of a petroleum deposit once discovered. Indeed, these predictions form the basis for C's decision as to the amount he will be willing to invest as well as the payout period of the production payment—an important factor in C's determination of an acceptable rate of return on his investment.

Second, in the ABC transaction, one production payment is reserved from *all* of the properties conveyed. The interest therefore will not terminate as to any one property until there has accrued to C, from the production of all of the properties, petroleum equal in value to his investment plus interest. If production from any property becomes impossible, C's interest is not reduced but rather becomes an increased burden on the remaining productive properties. Thus, the risk of geological factors making the transaction unprofitable is further diminished as the number of properties conveyed increases.

Third, the ABC production payment commonly utilizes one of several forms of variable dedication, so that the percentage of production accruing to C from each property fluctuates with the costs incurred by B in operating the wells on that property. The variable dedication is drafted so as to reduce the initial percentage dedication whenever the costs attributable to a property exceed B's income from it, so long as the production payment is paying out according to a schedule established in the instrument. When such a device is used, B will typically agree to a higher initial dedication since the possibility that increased costs will exceed his receipts from the purchased properties is minimized. Consequently, both the tax advantages to B and the rate of the return of C's investment are maximized and the interest costs from the transaction are thereby reduced.¹²

Finally, the ABC production payment instrument will set forth in detail the covenants and warranties of the parties. These will include warranties of title, provisions requiring B to market the petroleum accruing to C, and covenants by B to maintain production from each property subject to the production payment so long as is commercially feasible. Moreover, the instrument will commonly authorize C to assume the operation of the leases upon B's default on any of the covenants. There will also be provisions for incremental increases in the amount of the production payment to cover the closing costs and any subsequent expenses incurred by C as a result of the transaction.

Assuming that the ABC production payment is carefully drafted, it is clear that it is an adequate vehicle for determining the rights

12. See Beatty, *Selected Problems in Oil and Gas Financing*, 11TH ROCKY MT. MINERAL L. INST. 79 (1966).

and obligations of the participating parties. However, the extent to which the terms of the instrument can be enforced against third parties, especially creditors of the parties to the instrument, is much less clear. The volume of ABC transactions in recent years seems to indicate that this question has been resolved to the satisfaction of the investors' counsel.¹³ However, in many instances, the financial reputation of the buyer combined with the large number of properties and the substantial margin of excess proven reserves subject to the production payment may have overshadowed the legal risks involved. Today, the tax advantages of ABC financing are being sought in transactions which involve significantly fewer properties and less financially sound buyers. This increases both the risk of geological difficulties and the possibility that B's creditors will challenge the secured position of C. In such transactions, therefore, the degree of legal protection which will be afforded the ABC production payment is crucial.

II. THE LEGAL PROTECTION AFFORDED THE INVESTOR'S INTEREST

There are basically three situations in which the investor's interest in an ABC production payment may be subject to legal attack: (1) when a creditor of, or subsequent purchaser from, B (or C, where C has borrowed the funds with which the production payment was purchased) seeks to cut off the investor's interest; (2) when B (or C) becomes bankrupt; and (3) when a federal tax lien attaches to B's (or C's) property.¹⁴ Unfortunately for the purposes of this discussion, there is no case authority dealing with the ABC production payment's vulnerability to any of these attacks. The marked similarity between the ABC production payment and the single property payment suggests that the two interests may receive analogous treatment, but case authority on single property production payments is itself meager and frequently exhibits varying rationales and, occasionally, conflicting results. Moreover, in several jurisdictions which have only recently become important for oil and gas production, the courts have yet to consider either type of production payment.

A. *The Protection Afforded the ABC Production Payment Under State Laws*

The degree to which the investor in an ABC transaction will be protected against attacks by creditors or subsequent purchasers depends primarily on the extent to which the courts will be willing to recognize the ABC production payment as a proprietary interest in the underlying properties. The legal nature of the interests created

13. See Oberwetter, *supra* note 1, at 403.

14. A fourth situation which concerns defects in A's title to the properties from which the production payment is reserved is beyond the scope of this Comment.

also governs the extent to which the investor can rely on the remedial provisions of the production payment conveyance. The desired results can be substantially achieved by carefully drafting—that is, by emphasizing an intention to create an undivided interest in the mineral estate or lease and couching the remedial provisions of the instrument creating the production payment in terms of covenants burdening B's working interest. Nevertheless, it is possible that a court might disregard the language of the instrument and hold that the production payment created either (a) mere contractual rights against B, leaving the investor without protection against subsequent secured creditors; or (b) a security interest in the working interest of B, necessitating real property foreclosure procedures in case of default.

The approach which the courts of a given state can be expected to adopt toward an investor's rights as owner or mortgagee of a production payment will be determined largely by the legal nature attributed to oil and gas interests in the jurisdiction.¹⁵ In many states a petroleum interest is considered a corporeal estate in the oil and gas in place, analogous to, but severed from, the surface fee.¹⁶ Since a lessee's interest in the petroleum in the ground is also considered corporeal, the courts of these states have exhibited a willingness to recognize subordinate interests carved out of the *lease* as proprietary interests in real property by analogy to common-law incorporeal hereditaments.¹⁷ On the other hand, in another group of states, it is impossible to create possessory rights in oil and gas in place. In such jurisdictions, the petroleum lease is deemed a conveyance of the landowner's incorporeal rights to search for and develop any petroleum deposits under his land¹⁸ and the lessee cannot get title to the

15. For a tabulation of the various positions taken by the oil and gas producing states, see 1 WILLIAMS & MEYERS 17-166.

16. See, e.g., *Humphreys-Mexia Co. v. Gammon*, 113 Tex. 247, 254 S.W. 296 (1923) (severed mineral interests); *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923) (interest of an oil & gas lessee); cases cited in 1 WILLIAMS & MEYERS 94-98.

17. See, e.g., *Standard Oil Co. v. Marshall*, 265 F.2d 46 (5th Cir.), *cert. denied*, 361 U.S. 915 (1959) (Texas); *Connell v. Kanwa Oil, Inc.*, 161 Kan. 649, 170 P.2d 631 (1946). See generally March, *The Interest of Landowner and Lessee in Oil and Gas in Colorado*, 25 ROCKY MT. L. REV. 117 (1953); Matheson, *Colorado Oil and Gas Law*, 33 ROCKY MT. L. REV. 331 (1961); Wade, *Recent Mississippi Oil and Gas Cases*, 18 MISS. L.J. 243 (1947).

18. See, e.g., *Sun Oil Co. v. Oswell*, 258 Ala. 326, 62 So. 2d 783 (1953); *Dabney-Johnston Oil Corp. v. Walden*, 4 Cal. 2d 637, 52 P.2d 237 (1935); *Miller v. Ridgley*, 2 Ill. 2d 223, 117 N.E.2d 759 (1954); *Halbert v. Hendrix*, 121 Ind. App. 43, 95 N.E.2d 221 (1950); *Shields v. Fink*, 190 Kan. 17, 372 P.2d 252 (1962); *Central Ky. Natural Gas Co. v. Smallwood*, 252 S.W.2d 866 (Ky. 1952); *Wemple v. Nabors Oil & Gas Co.*, 154 La. 483, 97 So. 664 (1923); *Banach v. Home Gas Co.*, 23 Misc. 2d 556, 199 N.Y.S. 2d 858 (Sup. Ct. 1960), *aff'd*, 12 App. Div. 2d 373, 211 N.Y.S.2d 443 (1961); *Back v. Ohio Fuel Gas Co.*, 160 Ohio St. 81, 113 N.E.2d 865 (1953); *Rich v. Doneghey*, 71 Okla. 204, 177 Pac. 86 (1918); *Denver Joint Stock Land Bank v. Dixon*, 57 Wyo. 523, 122 P.2d 842 (1942). See also 2 TIFFANY, REAL PROPERTY § 589 (3d ed. 1939).

oil or gas until it is brought to the surface. Under this view, the analogy to the common-law corporeal-incorporeal distinction is not available to aid the courts in construing a production payment as a proprietary interest in real property. Although the results of single property production payment litigation have frequently been the same in these jurisdictions as they have been in states where the underlying lease is considered corporeal,¹⁹ the scope of protection which will be afforded the ABC production payment in these jurisdictions is less clear.²⁰

1. *The Legal Nature of the ABC Production Payment Where the Lessee's Interest Is Considered Corporeal*

Although, as noted above, there is virtually no relevant authority, it is possible to predict with some certainty the treatment which the ABC production payment will receive in courts adhering to the view that the lessee's interest is corporeal. This is due in part to the availability of the analogy to common-law incorporeal hereditaments, and in part to the relative abundance of case authority dealing with single property production payments in the leading jurisdiction in this group—Texas. In *Tennant v. Dunn*,²¹ the Texas Supreme Court held that rights under a recorded production payment could not be defeated by a subsequently appointed state court receiver of the oil and gas leasehold estate out of which the production payment had been created. Although the production payment was not construed to pass title to the oil and gas in place, it was characterized as an incorporeal interest in land, arising out of the lessee's corporeal mineral estate, and therefore entitled to the protection of the Texas recording act. Subsequent Texas cases have continued to view the production payment as realty, subject to taxation as real estate in the county where the property is located²² and governed by real property venue rules.²³ Although all of these cases involved single property production payments, there is no indication that their reasoning would not be equally applicable to an ABC production payment. Thus, it appears that C will be treated as the owner of a real property interest in states where the working interest in a petroleum lease is considered corporeal. Once recorded, C's

19. See text accompanying notes 51-53 *infra*. It has been suggested that the distinction made between corporeal and incorporeal, if literally applied, is illogical and absurd. SALMOND, JURISPRUDENCE 273 (10th ed. 1947).

20. See Walker, *supra* note 8, at 280.

21. 130 Tex. 285, 110 S.W.2d 53 (1937).

22. *O'Connor v. Quintana Petroleum Co.*, 134 Tex. 179, 133 S.W.2d 112 (1939), *petition for rehearing overruled*, 134 Tex. 191, 134 S.W.2d 1016 (1940).

23. *Humble Oil & Ref. Co. v. Monroe*, 129 S.W.2d 454 (Tex. Civ. App. 1939). See also *Standard Oil Co. v. Marshall*, 265 F.2d 46 (5th Cir. 1959), where a federal court applying Texas law held that a production payment is a non-possessory interest and as such cannot be the subject of an action of trespass to try title.

interest will be protected against creditors of B.²⁴ Similarly, if C borrows the purchase price of the production payment, the lender's mortgage will be afforded all of the dignity of a purchase-money mortgage of real property.²⁵

However, several of the possible variations of the standard ABC transaction may prevent it from receiving such favorable treatment. One of these is the variable dedication device which may make it impossible to ascertain C's share of the severed oil and gas until after the attributable operating costs are determined.²⁶ Nevertheless, Texas courts have been willing to recognize the analogous variable overriding royalty interests as an interest in real property, although these also involve similar determinations.²⁷ In addition, it is possible to draft the variable dedication so that it operates prospectively—C's share of production in one accounting period being determined by the costs incurred by B in a previous period. Such an approach thus preserves a high degree of certainty, by determining C's share prior to actual production, while achieving the desired tax consequences.²⁸

A second potentially problematic variation of the ABC transaction, even in states which view the standard production payment as real property, is the "proceeds" production payment which, in effect, entitles C to only a share of the proceeds from the petroleum when marketed, without granting him the option to take payment in kind. The inclusion of this variation would usually be at B's insistence. B would realize that it would be possible for C to generate tax losses over the first half of the production payment payout period, at the end of which time it would become advantageous for C to sell the production payment,²⁹ and that among the potential purchasers would be petroleum processors and distributors whose interest is occasioned by the opportunity to take payment in kind. However, since frequently B has purchased the properties in order to secure his own supply of crude oil, he would attempt to minimize the possibility that he might lose control over the disposition of petroleum accruing to the ordinary production payment. Thus, although the proceeds form is probably seldom used at present in ABC transactions, this variation may become more common.

Although early cases evidence a reluctance to treat a royalty in-

24. *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937).

25. *McCully v. McCully*, 184 Okla. 264, 86 P.2d 786 (1939).

26. For a description of the variable dedications and an analysis of the motivations behind its use, see Beatty, *supra* note 12, at 80-90.

27. *Arcadia Ref. Co. v. Cook*, 146 S.W.2d 767 (Tex. Civ. App. 1940); *Midas Oil Co. v. Whitaker*, 123 S.W.2d 495 (Tex. Civ. App. 1938); *Agey v. Barnard*, 123 S.W.2d 484 (Tex. Civ. App. 1938); see 2 WILLIAMS & MEYERS § 422.3.

28. Beatty, *supra* note 12, at 97-98.

29. *Spencer & Rowen, Acquisition of Oil and Gas Properties Through the ABC Transaction*, P-H OIL & GAS TAXES 2211, 2217 (1965).

terest without an option to take in kind as realty,³⁰ it now appears that, at least in Texas, the distinction between an interest with an option of payment in kind and one in which such an option is not present will not be observed. Indeed, this distinction has been rejected in cases dealing with land-owner royalty interests³¹ and in one case which involved liability for the ad valorem production tax attributable to a proceeds production payment.³² It is not clear, however, that other jurisdictions will be as willing to disregard the distinction.³³ The proceeds production payment, like a promise to pay money out of a fund to be created in the future, is uncomfortably similar to instruments which in other contexts have been construed to create either an equitable lien against the res out of which the fund is to be realized or a mere unsecured contract right as opposed to a real property interest.³⁴ While a careful drafter can emphasize that the method of payment is not intended to affect the nature of the interest created, C must consider the possibility that these exhortations will be disregarded. It should be noted that if the equitable lien analogy is adopted, C may nevertheless enjoy the status of a secured party; since the protection of real property recording acts typically extends to interests *affecting* realty, the recording of the production payment instrument may protect C's lien against subsequent purchasers of the leases and B's creditors.³⁵ On the other hand, as a lienholder, C may not be able to rely on the nonjudicial enforcement provisions of the production payment instrument and may well be forced to employ costly judicial foreclosure or receivership procedures if B defaults on his obligation.

Assuming that the ABC production payment is considered a present proprietary interest in real property, potential problems may also arise when an investor has loaned C the money with which C purchases the production payment. In the event that B defaults on

30. See *Compton v. Trico Oil Co.*, 120 S.W.2d 534 (Tex. Civ. App. 1938); *Harvey v. Bell*, 52 S.W.2d 281 (Tex. Civ. App. 1932). Compare *Trico Oil Co. v. Pelton*, 114 S.W.2d 1209, *motion to certify denied*, 120 S.W.2d 539 (Tex. Civ. App. 1938).

31. *Sheffield v. Hogg*, 124 Tex. 290, 77 S.W.2d 1021 (1934), *petition for rehearing overruled*, 124 Tex. 311, 80 S.W.2d 741 (1935). Royalties payable in money as well as royalties payable in kind are interests in land. See Beatty, *supra* note 12, at 106-08.

32. *O'Connor v. Quintana Petroleum Corp.*, 134 Tex. 179, 133 S.W.2d 112 (1939), *petition for rehearing overruled*, 134 Tex. 191, 134 S.W.2d 1016 (1940).

33. See *Elliot v. Sioux Oil Co.*, 191 F. Supp. 847 (D. Wyo. 1960), in which the court held that the proceeds of the sale of oil constituted an interest in real property.

34. See *Davis v. Lewis*, 187 Okla. 91, 100 P.2d 994 (1940); Vagts, *The Impact of the UCC on the Oil and Gas Mortgage*, 43 TEXAS L. REV. 825, 845-47 (1965); Walker, *supra* note 8, at 266-67; cf. *Stone v. Wright*, 75 F.2d 457 (10th Cir. 1935); *Harvey v. Bell*, 52 S.W.2d 281 (Tex. Civ. App. 1932).

35. *Stone v. Wright*, *supra* note 34; *Busby v. United States Steel Corp.*, 237 F. Supp. 602 (E.D. Okla. 1965); *Recovery Oil Co. v. Van Acker*, 79 Cal. App. 2d 639, 180 P.2d 436 (1947); *Recovery Oil Co. v. Van Acker*, 96 Cal. App. 2d 909, 216 P.2d 483 (1950); *Davis v. Lewis*, 187 Okla. 91, 100 P.2d 994 (1940); *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937); see 1 WILLIAMS & MEYERS 126.

his covenant to continue operating the properties subject to the production payment and C is unwilling or unable to advance the funds needed to resume production, the investor will then be forced to assume the operation of the leases, as he would be authorized to do under the terms of the production payment and the production payment mortgage. The amounts thus contributed to finance continued production will typically become an additional increment to the unpaid balance of the production payment. Since this operates only to extend the term of the production payment, C will clearly be entitled to realize the return of these advances, but it is not clear that, as to these amounts, C's lender will be granted priority over junior liens against the production payment. While the Uniform Commercial Code has validated chattel mortgages securing future advances in most jurisdictions,³⁶ such advances pursuant to a real property mortgage may be subordinated to a junior mortgage if the payments were not obligatory and were made with knowledge of the intervening security interest.³⁷ In one of the few cases dealing with conflicting security interests in oil and gas properties, the Tenth Circuit subordinated advances by a senior mortgagee of an Oklahoma oil leasehold where the advances were made after the mortgagee had notice of the junior interest.³⁸ The court noted, however, that the mortgagee was not required to make the advances either under the mortgage contract or to protect his security interest.³⁹ Although

36. UNIFORM COMMERCIAL CODE [hereinafter cited as U.C.C.] § 9-204(5) provides: "Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment." The relevant Comment remarks that "this subsection validates the future advance interest, provided only that the obligation be covered by the security agreement." See 2 GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 931-46 (1965).

37. OSBORNE, MORTGAGES §§ 276-303 (1951); 3 POMEROY, EQUITY JURISPRUDENCE § 1199 (4th ed. 1918); 5 TIFFANY, REAL PROPERTY § 1463 (3d ed. 1939). While this adequately states what is commonly accepted as the rule, several states allow the first mortgagee to prevail as to the future advances even if the advances are optional. *E.g.*, Gray v. Helm, 60 Miss. 131 (1882); Witzinski v. Everman, 51 Miss. 841 (1876); Jolly v. Fidelity Union Trust Co., 15 S.W.2d 68 (Tex. Civ. App. 1929); Poole v. Cage, 214 S.W. 500 (Tex. Civ. App. 1919). A third rule, the so-called Vermont doctrine, gives priority to the future advances unless the intervening lienor gives notice that no future advances are to be made on the security of the first mortgage. See *McDaniels v. Calven*, 16 Vt. 300, 42 Am. Dec. 512 (1844). In addition, the knowledge requirement varies among jurisdictions: actual notice is required in a majority of jurisdictions, but recordation of a subsequent mortgage provides the mortgagee with sufficient notice in others. 5 TIFFANY, REAL PROPERTY § 1464 (3d ed. 1939). See also cases cited in Annot., 138 A.L.R. 566, 579 (1942).

38. *Continental Supply Co. v. Marshall*, 152 F.2d 300 (10th Cir. 1945), *cert denied*, 327 U.S. 803 (1946).

39. *Id.* at 304. The implication that the advances would have been given priority if they had been made to protect the security is not without support. Several cases have treated such advances as obligatory if the mortgagee had the right to enter and complete a construction project independently of the will of the mortgagor. *E.g.*, *Rowan v. Sharp's Rifle Mfg. Co.*, 29 Conn. 282 (1860); *Bellamy & Sons v. Cathcart*, 72 Iowa 207, 33 N.W. 636 (1887); *cf. Hyman v. Hauff*, 138 N.Y. 48, 33 N.E. 734 (1893). However, the majority of cases reject this thesis, disallowing the priority of advances if the mortgagee could

earlier Oklahoma cases had classified oil and gas leases as chattels real for state tax purposes, the court nonetheless held that the Oklahoma statute validating chattel mortgages securing future advances did not apply to a mortgage on an oil lease.⁴⁰ Presumably, a production payment mortgage would receive similar treatment.

2. *The Legal Nature of the Payment Where the Lessee's Interest Is Considered Incorporeal*

The production payment is less likely to be considered a proprietary real property interest in those states in which the oil lease is considered an incorporeal hereditament. In many of these states the leasehold interest is itself considered personalty, although it is afforded many of the incidents of real property.⁴¹ At common law the analogous *profit à prendre* in gross was considered indivisible,⁴² but it is clear that undivided interests in the petroleum lease are everywhere valid⁴³ and that non-working interests, such as the single property production payment, have also been held valid.⁴⁴ Nevertheless, in the absence of an established category into which the production payment can be fitted, its legal nature has been variously defined. In Louisiana, for example, a production payment has been held to be merely evidence of debt.⁴⁵ In other jurisdictions, it has been treated as a personal property interest,⁴⁶ a mortgage,⁴⁷ or an equitable lien,⁴⁸ while in still others, the courts have yet to consider the nature of such an interest.⁴⁹ The ABC production payment is especially suitable to classification as a mortgage,⁵⁰ for although many production payments are speculative investments, which are intended

decline to make the advances. *E.g.*, *Althouse v. Provident Mut. Bldg. & Loan Ass'n*, 59 Cal. App. 31, 209 Pac. 1018 (1922); *In re Harris*, 156 Misc. 805, 282 N.Y. Supp. 571 (Surr. Ct. 1935); *Elmendorf-Anthony Co. v. Dunn*, 10 Wash. 2d 29, 116 P.2d 253 (1941).

40. *Continental Supply Co. v. Marshall*, 152 F.2d 300, 305 (10th Cir. 1945), *cert. denied*, 327 U.S. 803 (1946).

41. 1 WILLIAMS & MEYERS 123-55.

42. POWELL, REAL PROPERTY §§ 418-19 (1952); 1 WILLIAMS & MEYERS 118; see, *e.g.*, *Caldwell v. Fulton*, 31 Pa. 475 (1858).

43. 1 WILLIAMS & MEYERS 118-19.

44. See Walker, *supra* note 8, at 259.

45. *Posey v. Fargo*, 187 La. 122, 174 So. 175 (1937). Recent legislation may have overruled the case, LA. REV. STAT. ANN. § 9:1105 (1965); however, the Louisiana courts have been hesitant to give effect to this legislation and *Posey* may therefore still represent the law of Louisiana. See *Tinsley v. Seismic Explorations, Inc.*, 239 La. 23, 117 So. 2d 897 (1960).

46. See *McCrae v. Bradley Oil Co.*, 148 Kan. 911, 84 P.2d 866 (1938).

47. See *National Bank v. Warren*, 177 Kan. 281, 279 P.2d 262 (1955) (assignment of oil payments as security for loan was a mortgage of real estate within the meaning of the applicable statute requiring payment of a mortgage registration fee). See also *Tenant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937).

48. See *Davis v. Lewis*, 187 Okla. 91, 100 P.2d 994 (1940).

49. See Walker, *supra* note 8, at 270-71.

50. *Cf. Standley v. Graham Prod. Co.*, 83 F.2d 489 (5th Cir.), *cert. denied*, 299 U.S. 593 (1936).

to spread the risks of explorations and development and therefore resemble an equity investment, the ABC transaction is designed to finance the sale of properties with proved reserves.

Despite the uncertainty in these states as to the exact nature of an ABC production payment, it appears that the investor's interests can be given the same protection afforded other chattels real. Even where an oil and gas lease is considered personal property, it may be protected by real property recording statutes as an interest affecting realty,⁵¹ and production payments have also frequently been held to be within the scope of such recording acts.⁵² Indeed, in Kansas, where production payments have been consistently labeled as personalty, a security assignment of a production payment has been held to be a mortgage of real estate within the meaning of a statute requiring payment of a mortgage registration fee.⁵³ Nonetheless, it is possible that, in some jurisdictions, an ABC production payment will be treated as creating either an interest limited to the oil and gas when brought to the surface, or a mere contractual right against B. This possibility has been generally discounted by oil and gas practitioners,⁵⁴ for although early cases in several jurisdictions adopted one or the other of these views, these cases have rarely been followed.⁵⁵ Clearly, policy considerations support this result. Local real property records offer a convenient opportunity to give notice of production payments to third parties dealing with the working interest owner and the proliferation of interests to which the typical oil and gas lease is subject is so widely recognized that it is doubtful that anyone would in good faith enter into a transaction with the operator of a lease without first examining the real property records. The non-ABC production payment provides flexibility in financing the development of oil and gas deposits and therefore merits protection against subsequent creditors and purchasers. Despite the fact that the ABC production payment may be used only as a tax avoidance device, this alone does not justify a different result. However, the history of the court's treatment of the production payment emphasizes the fact that slight drafting oversights pose a significant risk to the ABC investor in jurisdictions in which the security aspects of production payments have not yet been fully litigated.

Because of the tendency in many jurisdictions to consider a pro-

51. See, e.g., *Derby Oil Co. v. Bell*, 134 Kan. 489, 7 P.2d 39 (1932); CAL. CIV. CODE § 1214 (West 1954); MINN. STAT. § 507.01 (1961); MONT. REV. CODE ANN. § 73-202 (repl. vol. 1962); NEB. REV. STAT. § 76-201 (1943); S.C. CODE ANN. § 8875 (1962); TEX. REV. CIV. STAT. ANN. § 6627 (1936); VA. CODE ANN. §§ 5192, 5194 (1936).

52. *Stone v. Wright*, 75 F.2d 457 (10th Cir.), *cert. denied*, 295 U.S. 754 (1935); *Davis v. Lewis*, 187 Okla. 91, 100 P.2d 994 (1940), applying OKLA. STAT. tit. 16, § 15 (1961).

53. *National Bank v. Warren*, 177 Kan. 281, 279 P.2d 262 (1955); *cf. Riverview State Bank v. Ernest*, 198 F.2d 876 (10th Cir.), *cert. denied*, 344 U.S. 892 (1952).

54. See 2 WILLIAMS & MEYERS 370-71.

55. See *Walker*, *supra* note 8, at 266, 270-71.

duction payment as personalty, it is customary to record mortgages against ABC production payments both as real estate mortgages *and* as security interests under the Uniform Commercial Code.⁵⁶ The possibility that these security interests might be governed by the Code offers certain advantages to the lender because the holder of a production payment mortgage may thus acquire priority over subsequent lienors as to future advances.⁵⁷ In addition, if the production payment is construed as creating an interest only in the petroleum when brought to the surface, the Code provides that the mortgage would be valid as to this after-acquired property against other creditors of C.⁵⁸ Even if B is considered to be under only a contractual obligation, it is possible through Code-filing to perfect a security interest in the contract rights of C⁵⁹ and thus obtain the same protection as a chattel mortgage. Finally, the nonjudicial foreclosure provisions of the Code⁶⁰ are frequently more attractive to the lender than are the less flexible procedures available under real property mortgage law.⁶¹

B. *The Protection Afforded the ABC Production Payment in Bankruptcy*

It is apparent that the investor's security in an ABC production payment is more vulnerable to attack by a trustee in bankruptcy than by creditors generally. This is primarily because of the additional "avoiding" weapons available to the trustee, one of the most significant of which is his ability to attack voidable preferences under section 60 of the Bankruptcy Act.⁶² Pursuant to section 60, the trustee

56. U.C.C. § 1-201(37). See also *id.* § 9-302 (filing requirements). The Code filing also protects a lender's interest in C's accounts receivable generated from the production payment and customarily assigned to the lender in the mortgage agreement. U.C.C. § 9-102(a).

57. U.C.C. §§ 9-204(5), -301(1)(b).

58. U.C.C. §§ 9-204(3), -301(1)(b). Article 9 of the Code does not apply to an interest in or a lien on real estate other than fixtures. U.C.C. § 9-104(j). The Code may also offer a means of protecting C's interest in petroleum which has been brought to the surface and is being stored by B for later sale pursuant to B's covenant to market petroleum accruing to C. As a readily saleable commodity, this petroleum is a particularly attractive subject for attachment by B's creditors. Since C has allowed his portion of the extracted petroleum to remain in the possession of B, C's portion is subject to the claims of B's creditors. U.C.C. §§ 2-326(2) & (3). However, by filing a financing statement, giving notice of the marketing covenants of the production payment conveyance and C's rights in the petroleum being stored by B, C may be protected. U.C.C. § 2-326(3)(c). This type of filing is more crucial in ABC transactions involving hard minerals, which are normally stockpiled by the mine operator six months or longer before being sold. It is less important in the petroleum situation since petroleum is usually sold to pipeline operators (or C's portion is bought by B) immediately upon extraction.

59. U.C.C. §§ 9-102(1), -106.

60. U.C.C. §§ 9-501 through -507.

61. See generally Beatty, *supra* note 12, at 111-18; Vagts, *supra* note 34, at 825.

62. Bankruptcy Act § 60, 64 Stat. 24 (1950), 11 U.S.C. § 96 (1954).

A preference is a transfer, as defined in this Act, of any of the property of a debtor

may be able to collect payments made to C within the four months preceding B's bankruptcy.⁶³ It has been argued that even if these payments are recaptured, the result may not be disastrous since the amount lost would be insignificant when compared to the total value of the interest.⁶⁴ However, the possibility of these losses should not be ignored, particularly since careful drafting can substantially eliminate the risk. Indeed, two Fifth Circuit cases, decided on the same day, clearly indicate that variations in the wording of an agreement can determine whether the production payment will be treated as a present security interest in real property or as a lien interest which does not arise until the petroleum reaches the surface.⁶⁵ If C's right is construed as a present security interest, payment thereunder would not be preferential,⁶⁶ whereas if C's lien interest does not arise until the petroleum has been produced, interests acquired within four months of bankruptcy may be preferential as after-acquired property.⁶⁷ Initially, it should be noted that a security agreement which covers after-acquired property is valid under the Uniform Commercial Code.⁶⁸ A conflict arises between the holder of the security interest and the trustee when rights in the oil are created within four months of bankruptcy. To establish a preference, it must be shown that there was "a transfer . . . for or on account of an antecedent debt . . . within four months before the filing . . ."⁶⁹ This presents two separate issues. The first, whether the transfer was within four months of filing, is clearly satisfied since the transfer is deemed to occur when the security interest becomes perfected as against subsequent lienholders⁷⁰ and, under the Code, the security interest becomes so perfected when the debtor has acquired rights in the collateral⁷¹—that is, when the oil is brought to the surface. The second

to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

Bankruptcy Act § 60a(1), 64 Stat. 24 (1950), 11 U.S.C. § 96 (1964).

63. § 60b, 64 Stat. 24 (1950), 11 U.S.C. § 96 (1964).

64. Vagts, *supra* note 34, at 844.

65. In *Standley v. Graham Prod. Co.*, 83 F.2d 489 (5th Cir.), *cert. denied*, 299 U.S. 593 (1936), the court found an assignment to create an interest in the oil only after it had been separated from the ground, relying on the language of the agreement creating the interest in the oil ". . . if, as and only when same is produced." Applying the law of the same state in *Berry v. Harrell*, 83 F.2d 671, 673 (5th Cir.), *cert. denied*, 299 U.S. 559 (1936), the court found that an assignment "in terms vested an interest in the land . . ."

66. 3 COLLIER, BANKRUPTCY § 60.22 (Supp. 1966).

67. See text accompanying note 76 *infra*.

68. U.C.C. § 9-204(3).

69. § 60(a)(1), 64 Stat. 24 (1950), 11 U.S.C. § 96 (1964).

70. § 60(a)(2), 64 Stat. 24 (1950), 11 U.S.C. § 96 (1964).

71. Under the UCC, a security interest prevails over a lien creditor only after it is perfected, § 9-301(1)(b). If a financing statement has been filed, a security interest

issue is more troublesome, namely, whether the transfer was for an antecedent debt. Standard bankruptcy doctrine holds that a transfer is for an antecedent debt if no consideration is given simultaneously,⁷² but the Code provides that this transfer "shall be deemed to be taken for new value and not as security for an antecedent debt."⁷³ Unfortunately, this apparent conflict has not yet been resolved by the courts and is beyond the scope of this Comment.⁷⁴

Other weapons of the trustee are also affected by the nature of C's interest. In jurisdictions which construe C's interest as a mere contract right, the trustee may be able to prevail over C by virtue of the trustee's status as a perfected lien creditor.⁷⁵ Indeed, if the contract is deemed to be merely executory, the trustee may reject it completely, leaving C with only a claim for breach of contract.⁷⁶ Therefore, absent some underlying security or evidence of debt, the position of an investor in these jurisdictions seems almost prohibitively precarious. On the other hand, the investor's position seems relatively secure in jurisdictions which treat the interest acquired as an interest in real property since the interest is thus protected by the recording acts.

Where the ABC transaction is financed through a loan to C, the investor is faced with the additional contingency of C's bankruptcy. However, it is unlikely that this possibility will be of great concern to the investor. In most instances, C will be a corporation which has been set up solely for the purpose of holding the production payment. Although the capitalization of the corporation will be nominal, it is unlikely to have any debts other than those to the lender and tax liabilities. Therefore, if C becomes bankrupt, C's lender, as his only creditor, will, in effect, step into C's shoes with respect to B's obligation to C.

C. *The Production Payment and the Federal Tax Lien*

Perhaps the only significant commercial justification for the ABC transaction is the belief that it offers the lender additional protection against a federal tax lien. This belief is based, in part, on the idea

becomes perfected when it has attached, § 9-303(1). A security interest cannot attach until the debtor has rights in the collateral, § 9-204(1), which occurs when the oil is extracted, § 9-204(2)(b).

72. 3 COLLIER, BANKRUPTCY § 60.19 (Supp. 1966).

73. U.C.C. § 9-108.

74. See generally 2 GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.6 (1965); Note, 65 MICH. L. REV. 1004 (1967).

75. § 70(c), 80 Stat. 268 (1966), 11 U.S.C.A. § 110 (Supp. 1966).

76. § 70(b), 76 Stat. 571 (1962), 11 U.S.C. § 110 (1964), permits the trustee to assume or reject any executory contract. If the contract is rejected, however, C has a claim for breach of contract under § 63(c), 66 Stat. 426 (1952), 11 U.S.C. § 103 (1964), which is provable against the bankrupt's estate under § 63(a)(9), 52 Stat. 873 (1938), 11 U.S.C. § 103 (1964).

that a proprietary interest is less likely to be subordinated to a federal tax lien than is a security interest. However, this proposition finds support in only a single reported case wherein the Internal Revenue Service contested the priority of a production payment⁷⁷—a case which was unconcerned with the type of production payment found in an ABC transaction and is weak authority even on its own facts. While admittedly the Service has been willing to distinguish the ABC transaction from the conventional secured loan for the purpose of establishing tax liability,⁷⁸ it does not necessarily follow that it will be willing to observe such a distinction in its collection activities. Moreover, a court is not likely to receive favorably the argument that the ABC method of financing ought both to reduce B's taxes and also remove from the grasp of the government property against which tax liability could otherwise be enforced.

The suggestion that the ABC production payment is insulated from federal tax liens was derived principally from the "no property" doctrine announced by the Supreme Court in *Aquilino v. United States*⁷⁹ and *United States v. Durham Lumber Co.*⁸⁰ In both cases, unpaid subcontractors asserted priority over tax liens assessed against the general contractor. The subcontractors prevailed on the ground that under state law the contractor-taxpayer held any amount received or owing under the general contract in trust for the benefit of unpaid subcontractors, and since the tax lien applied only to property "belonging to" the taxpayer,⁸¹ it could not be enforced against property held by him in trust. Since a production payment is generally considered a *separate* property interest under state law, the reasoning of the *Aquilino* and *Durham Lumber* decisions would indicate that B, the owner of the working interest, has "no property" interest in the amounts accruing to the production payment. B may thus be said to hold these amounts "in trust" for the benefit of C and therefore all amounts accruing to the production payment are removed from the reach of a tax lien against B.⁸²

For purposes of determining priority over a subsequent tax lien, the Internal Revenue Code does not appear to give any greater consideration to a production payment purchaser than to a mortgagee

77. *Elliott v. Sioux Oil Co.*, 191 F. Supp. 847 (D. Wyo. 1960).

78. See *Thomas v. Perkins*, 301 U.S. 655 (1937); Treas. Reg. § 1-611.1(b) (1965).

79. 363 U.S. 509 (1960).

80. 363 U.S. 522 (1960).

81. INT. REV. CODE OF 1954, §§ 3670-71.

82. See 2 GILMORE, *op. cit. supra* note 74, § 40.5, at 1071. Recent decisions by lower federal courts had raised some doubts as to whether the "no property" doctrine is still good law. See *Fine Fashions, Inc. v. United States*, 328 F.2d 419 (2d Cir. 1964); *United States v. Toys of the World Club, Inc.*, 288 F.2d 89, 91 (2d Cir. 1961). *But see Berns Constr. Co. v. Highley*, 332 F.2d 240 (7th Cir. 1964); *In re Halprin*, 280 F.2d 407 (3d Cir. 1960). See generally Note, *Property Subject to the Federal Tax Lien*, 77 HARV. L. REV. 1485 (1964).

of the working interest in the property. In fact, the rights of a purchaser will in some instances be less; in order for the sale to be valid as against a present tax lien subsequently filed it must be valid as against a subsequent purchaser without actual knowledge,⁸³ whereas a security interest, to gain a similar priority, need only be valid as against a subsequent judgment creditor.⁸⁴

Regardless of whether the production payment is considered proprietary or security under local law, the uncertainties inherent in production payment financing raise a further question: Whether the interest is sufficiently "choate" or specific to receive priority over a subsequent tax lien.⁸⁵ Despite the recent changes in section 6323 of the Code as a result of the enactment of Public Law 89-719,⁸⁶ it will be difficult to answer this question with any certainty until the amendments have been tested in the courts. Although the legislative history of P.L. 89-719 indicates that it represents congressional reaction to at least some aspects of the choateness doctrine,⁸⁷ it is questionable whether it will trigger a general change in the courts' attitude. Nevertheless, a few points deserve consideration.

First, prior to the enactment of P.L. 89-719, it was clear under section 6323 that, at least to the extent a production payment was expanded by expenses incurred by C after the filing of the tax lien against B, the tax lien would have had priority.⁸⁸ As noted above,⁸⁹ in the event of a default by B, C may be authorized to step in and take over production, pay outstanding liens, and otherwise protect his interest. Although the cost of this activity becomes an incremental addition to the production payment, if the costs were incurred after the tax lien had been filed, they would have been subordinated to the lien. Since the ABC production payment is generally drafted so that these subsequent advances are paid out of C's share of production before any amount is applied to the unpaid balance of the production payment, it was possible for a tax lien to gain priority as to a major share of subsequent production where the subsequent advances were substantial. The recent amendment to the Code would change this result and clearly grant priority to this type of expenditure where, as here, it relates to the enforcement or preservation of a *security interest*.⁹⁰ However, there is no statutory requirement that

83. INT. REV. CODE OF 1954, §§ 6323(a) & (h)(6).

84. INT. REV. CODE OF 1954, § 6323(h)(1).

85. See generally Vagts, *The Impact of the UCC on the Oil and Gas Mortgage*, 43 TEXAS L. REV. 825, 843 (1965).

86. Pub. L. No. 89-719, 89th Cong., 2d Sess. (Nov. 2, 1966).

87. S. REP. NO. 1708, 89th Cong., 2d Sess., U.S. CODE CONG. & ADMIN. NEWS 4946 (1966).

88. See, e.g., *United States v. Pioneer Am. Ins. Co.*, 374 U.S. 84 (1963); *Continental Supply Co. v. Marshall*, 152 F.2d 300 (10th Cir. 1945), *cert. denied*, 327 U.S. 803 (1946).

89. See text at page 1209 *supra*.

90. INT. REV. CODE OF 1954, § 6323(e).

a similar principle be applied when an otherwise valid *proprietary interest* adverse to the taxpayer is sought to be expanded through expenditures made after a tax lien is filed. In view of the sympathetic attitude toward tax collectors shown in the past by the courts,⁹¹ it is unlikely that such a priority will be judicially created.

Second, if the production payment is viewed as a security interest and the state recognizes rights only in surfaced oil, the tax lien may prevail as to subsequently produced oil.⁹² However, if the production payment is treated as an interest in real property, C's interest in the petroleum in the ground should not be subordinated to the tax lien. Thus C's loss will be no greater than his share of the oil and gas produced between the time the tax lien arises and the time that the working interest is sold or the lien otherwise released.⁹³

Finally, the uncertainties inherent in production payment financing raise the general questions of "choateness" which have haunted lenders (and well-advised production payment purchasers) ever since *United States v. R. F. Ball Construction Co.*⁹⁴ While there is no reason that the ABC production payment should receive more protection against a tax lien than a mortgage upon an oil lease, neither is there any reason why it should fare worse. Although the rate of payment out of a production payment may be subject to the vicissitudes of production and state regulatory agencies, it is equally possible for repayment of any loan to fall behind schedule or be accelerated through a prepayment option. The interests of C and any lenders in the properties subject to the production payment should thus be sufficiently "choate" to be secure against subsequent tax liens.

*John T. Schmidt**

91. 2 GILMORE, *op. cit. supra* note 74, § 40.4.

92. Under the general priority provision of § 6323, a perfected security interest prevails over a tax lien which has not been notice filed. INT. REV. CODE OF 1954, § 6323(a). Since, for purposes of this provision, a security interest exists only if the collateral is in existence, § 6323(h)(1), it is arguable that the tax lien prevails. On the other hand, the tax lien also does not attach until rights in the collateral come into existence. Thus, because both attach at the same time, it could be argued that the two interests should share ratably. This possibility has not been precluded by any Supreme Court decision.

93. This is the same result as is obtained in the above situation where C's interest is expanded by expenses incurred after the filing of the tax lien.

94. 355 U.S. 587 (1958).

* The author gratefully acknowledges the assistance of Daniel C. Molhoek and Ronald R. Glancz, members of the Editorial Board of the *Michigan Law Review*.