Client Alert *March 14, 2016*

Production Payments Expire with the Burdened Lease

At the end of February, the Texas Supreme Court released an opinion in *Apache Deepwater, LLC v. McDaniel Partners, Ltd.*, 14-0546, 2016 WL 766731 (Tex. Feb. 26, 2016), confirming that production payments exist only as long as the burdened lease, reversing an appellate court decision that had troubled many in the oil and gas industry.

Production payments entitle their owner to a share of production from an oil and gas lease free of production costs. They generally terminate after a certain amount of money or volume of production is reached. Until 2014, the great weight of legal authority treated production payments similarly to overriding royalty interests in holding that, in the absence of an express savings provision, they also terminate if the underlying lease terminates.

However, in March of 2014, the El Paso Court of Appeals issued a decision in the *McDaniel* case, allowing for production payments to outlive the encumbered leases. This opinion, if upheld by Texas's highest court, would have changed the legal landscape and likely resulted in considerable production payment litigation. In its recent opinion, though, the Texas Supreme Court reversed the appellate court and upheld the trial court's take nothing verdict, holding that Apache owed no duty to make production payments to McDaniel on expired leases.

McDaniel's predecessor assigned four leases to Apache's predecessor in the same instrument, reserving 1/16th of total production from the portion of the mineral estate covered by the leases after subtracting the lessors' 1/8 royalty interest, "being one-sixteenth of the entire interest in the production from said lands to which Assignor claims to be entitled under the terms of said respective oil and gas leases." *Id.*, at *3. The assignment provided that the production payment would continue until a total payment of $3.55 million on 1.42 million barrels.

Two of the four leases accounted for a large majority of the leasehold interest conveyed. After these two leases expired, Apache acquired new leases and paid McDaniel on a proportionately reduced basis. McDaniel sued, lost the bench trial, and appealed. The appellate court remanded the case back to the trial court to calculate damages, holding that Apache could not adjust the production payment equation downward based upon the expiration of some leases, because the assignment contained no express language allowing for such a reduction.

The Texas Supreme Court dissected the production payment into two parts: the fractional share of production payment obligation and the total amount to be paid before termination of the interest. The Court determined that the assignment did not allow for an adjustment of the total amount, but the fact that this figure was fixed did not affect Apache's ability to adjust the fractional payment.

The Court found that although the instrument included all four leases and stated the cumulative working interest as a single fraction, this was not dispositive evidence of intent to carve the production payment out of the entire working interest. Focusing on the word "respective" in the reservation, the Court held that the production payment interest was tied to production from each respective *lease* and rejected McDaniel's argument that the production payment was payable out of production from the covered *lands*. Therefore, the Court approved Apache's proportionate reduction of the payment based on expired leases despite the fact that no express proportionate reduction provision appeared in the assignment, reversed the court of appeals, and reinstated the trial court's take nothing verdict.

The opinion can be found here. At the time of this Client Alert, the court has not ruled on McDaniel's request for a rehearing.

If you have questions about the information contained in this Client Alert, please contact the attorneys listed below or the Thompson & Knight attorney with whom you regularly work.

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