

Facilitating Collaborative Opportunities

The New AAPL Model Form Participation Agreement

In the summer of 2022, the Executive Committee and board of directors of the American Association of Professional Landmen approved the first ever Model Form Participation Agreement endorsed by the association. The PA form was subsequently made available in the "forms" section of the AAPL website.

The PA form resulted from the work of an ad hoc committee organized by the AAPL Forms Committee five years earlier. Co-chaired by Oklahoma City landman Dorsey Roach, CPL, and Dallas landman Dave Harper, CPL/CPA,¹ the ad hoc committee subsequently renamed itself the Participation Agreement Drafting Committee. The progress of the PADC was reported on in a paper at the 2018 Rocky Mountain Mineral Law Foundation Annual Institute by Roach and Harper.²



by/ PAUL YALE, CPL

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- 1 Other original members of the PADC who saw the work through to the end included Amarillo, Texas, landman Debbie Dominguez, RPL; Denver, attorney Howard Boigon; and Houston attorney Paul Yale, CPL. Additional AAPL members along the way brought a nationwide perspective to the PADC's work and an extensive peer review by other landmen and attorneys was undertaken before the PA form was finalized and presented to the AAPL board.
 - 2 Dorsey T. Roach & David Harper, A New AAPL Model Form Participating Agreement, A Comprehensive Form for Structuring Deals and Providing Deal Terms. Presentation to the Landman's Section at the 64th Annual Rocky Mountain Mineral Law Institute (July 21, 2018). (Not included in the published institute proceedings.)

The purpose of this article is to introduce the PA in its final form to AAPL membership and others who are interested. Following an overview of participation agreements in general, The article discusses the overall structure of the PA and what distinguishes it from other participation agreement forms that readers may have encountered. It also summarizes the key provisions of the PA, includes practice pointers for utilizing the PA form and concludes with some general comments and observations.³

BACKGROUND

The term "participation agreement" as used in the oil and gas industry can mean different things to different people. The William & Meyers oil and gas treatise defines the term as an agreement whereby "certain parties agree to participate, usually by the contribution of capital, in an exploration and/or development project."⁴

Perhaps a better way of thinking about participation agreements is to consider what they are not. They are rarely intended to be joint venture or partnership agreements, and the PA contains a specific disclaimer to this effect in Article XVII. This is for reasons of avoiding joint or collective liability and the tax consequences that can result from a partnership structure.

Participation agreements can also be distinguished from joint operating agreements. JOAs are frequently attached to participation agreements

but serve a different purpose. Joint operating agreements govern the day-to-day operations of wells drilled and produced by working interest owners and remain effective beyond the initial drilling phase for life of lease or life of field. Participation agreements are transactional agreements that provide the deal terms between two or more parties and are typically limited in scope to the initial exploration phases of a prospect, with a JOA superseding the PA when the development phase begins.

A participation agreement, in further contrast to a joint operating agreement, usually describes what it will cost a participant to buy into a prospect generator's drilling deal and typically involves "front-end loading," also known as a "promote," through which a buyer pays a greater share of the exploration and development costs than the seller as part of the consideration the seller is receiving for having identified the prospect and putting the deal together.⁵ Perhaps the classic participation agreement structure is the "third for a quarter" deal by which a seller transfers three quarters of the leasehold interest in a prospect to a buyer in exchange for the participants paying 100% of the cost of drilling and completing the initial well on a prospect.⁶

Participation agreements can also be distinguished from farmout agreements, though farmout agreements are close cousins. Williams & Meyers defines a farmout

agreement as "a form of agreement between operators, whereby a lease owner not desirous of drilling at the time agrees to assign the lease, or some portion of it (in common or in severality) to another operator who is desirous of drilling the tract."⁷ The farmor in a farmout arrangement typically assigns 100% of its leasehold to a farmee in exchange for the farmor's reservation of an overriding royalty with the option to convert it, after payout, to a working interest. As further consideration the farmee usually commits to drill a well or wells on the farmor's lease, at the farmee's sole cost, risk and expense.

Participation agreements may be near identical to farmout agreements in structure, with the main difference being that the seller in a participation agreement will often operate the wells with the buyer agreeing to bear a "promote" as part of the consideration the seller is receiving, as in the "third for a quarter" example referenced. Nevertheless, distinctions between farmouts and participation agreements can be subtle.

To further complicate, the term "participation agreement" as it is used in the oil and gas industry is often utilized interchangeably with terms such as "exploration agreement"⁸ or a development agreement, a joint development agreement or a combination of such terms, such as an "exploration and development agreement,"⁹ or even an "acquisition, exploration

3 The author thanks Dorsey Roach and Debbie Dominguez for their comments and assistance in drafting this article.

4 *Participation Agreement*, WILLIAMS & MEYERS MANUAL OF OIL AND GAS TERMS (18th ed. 2021).

5 *Front-end loading*, WILLIAMS & MEYERS MANUAL OF OIL AND GAS TERMS (18th ed. 2021).

6 See *Third-for-a-quarter deal*, WILLIAMS & MEYERS MANUAL OF OIL AND GAS TERMS (18th ed. 2021) ("[I]f the deal included three people plus the operator, then each person (other than the operator) would put up one third of the drilling cost and would receive a one-quarter interest in the well. The operator's quarter interest in the well is its reward for searching for, identifying, and leasing the prospect as well as the efforts it exerts in supervising the actual drilling and completion.")

7 *Farmout Agreement*, WILLIAMS & MEYERS MANUAL OF OIL AND GAS TERMS (18th ed. 2021).

8 Williams & Meyers defines an "exploration agreement" as "[a] contract providing for the joint exploration and development of a given prospect or land area." *Exploration Agreement*, WILLIAMS & MEYERS MANUAL OF OIL & GAS TERMS AGREEMENT" (18th ed., 2021). The term "exploration agreement" can include a broad range of agreements ranging from simple, single well joint operating agreements to large federal exploration units covering tens of thousands of acres or more. *Id.*

9 See Debra J. Villarreal & Lucas LaVoy, *Participation Agreements*, 31 E. Min. L. Found. 10, Appx. I (2010).

and development agreement.¹⁰ The differing terminology used to describe participation agreements reflects the wide variety of objectives that parties to the agreement may have.

For example, some participation agreements include provisions for shooting or purchasing seismic to develop prospects. In other participation agreements a prospect generator has already shot or acquired seismic and defined a drillable prospect that is then sold to participants to finance drilling and completion operations. Some participation agreements are designed for the initial drilling phase of a single prospect and end when subsequent operations are covered by a single JOA contract area. Other participation agreements cover vast areas and contemplate multiple prospects with multiple JOA contract areas.

Early on the PADC decided when approaching the task of drafting a model form agreement that the name "participation agreement" was a better choice than the variety of other terms used by industry to describe such arrangements because the word "participation" focused the agreement on its core issue — how to allocate working interest percentages and costs. Hence the title given to the PA form, "AAPL Model Form Participation Agreement."

Regardless of what title is used, participation agreements can be considerably more complex than the classic "third for a quarter" drilling deal

and can involve numerous options and variations as well as differences in scope and scale. The sheer variety of possible deal structures led one eminent Texas oil and gas lawyer to suggest that an effort to put together a form agreement for such purposes would be foolhardy.¹¹

Other commentators have also expressed skepticism of standard form participation agreements.¹² Foolhardy or not, the charge of the PADC was to do just that — develop a model form participation agreement that could be used in multiple jurisdictions for a wide variety of well trades, especially those prospects and deals that are commonly sold at NAPE. It is hoped that the introduction of a model form PA will enable documenting well trades at NAPE and elsewhere to be easier and quicker. It was also the goal of the PADC to develop a model form that would become widespread in use by industry. Only time will tell if the PADC's goals were met.

STRUCTURE

As part of its process the PADC collected and reviewed a large number of sample participation agreements, some bearing the name "participation agreement" and others bearing names like "exploration agreement," "development agreement" and so forth. As would be expected the content and structure of the agreements varied widely and in each case was very deal specific.

This is because the historic approach to participation agreements has been to negotiate the deal, then draft a customized, deal specific contract.

Taking a different approach, the PADC identified the most common features and alternatives used in participation agreements and incorporated those into a form that could be customized by filling in blanks and checking boxes.

For example, assume that two parties — a prospect generator, and a participant— wish to enter into a drilling deal with the following terms:

1. Seller to be paid \$10 million in upfront prospect buy-in costs; buyer gets an assignment upon payment of such costs.
2. Seller retains an overriding royalty in its leases equal to the difference between existing burdens and 25%.
3. Seller to be carried, through the tanks, with a 25% working interest in the initial test well.
4. All wells drilled after the initial test well governed by a JOA with seller (now operator) owning 75% and buyer (now nonoperator) owning 25%, with no further well carries.
5. Three-year term of agreement with coincident area of mutual interest. AMI acquisitions are not subject to seller's override.
6. No tax partnership; no arbitration unless agreed; Texas law and venue in Harris County, Texas.

10 See Steven B. Richardson & Peter D. Robinson, "Comprehensive Exploration Agreements," *Oil & Gas Agreements: The Exploration Phase*, Paper No. 9, Appx. II, ROCKY MT. MIN. L. INST. 9-1 (2010).

11 "In this author's experience, the form of exploration agreements is as varied as the companies and individuals who explore for oil and gas and the exploration trades they put together. It would be foolhardy then to suggest there is a usual form of exploration agreement. Moreover, it would be an insurmountable task to analyze and present the law in each jurisdiction that might be applicable to the drafting of the various provisions of a complex exploration agreement." Alan D. Cummings, "Complex Exploration Agreements: Getting Down to Business," *Oil & Gas Agreements: The Exploration Phase*, Ch. 7, ROCKY MT. MIN. L. INST. 7-1 (2004). Note: though an "exploration agreement" was referred to the sentiment could be inferred to apply to "participation agreements" to the extent that the author drew any distinction between the two.

12 See Karen E. Lynch, "Diagram of an Exploration Agreement: Legal and Practical Pointers for Promoters and Participants," 43 ROCKY MT. MIN. L. INST. § 1701-17-1 (1997) ("While 3-D exploration activities will probably never lend themselves to 'fill-in-the blank' documentation..."); see also Richardson and Robinson, *supra* note 9, at 1 ("Unlike other common agreements in the oil and gas industry, there is no 'standard form' of exploration and development agreement"); see also Villarreal and LaVoy, *supra* note 8, at § 10.03 ("There is certainly no one form of participation agreement.") Nevertheless, both Richardson & Robinson in their 2010 paper for the Rocky Mountain Mineral Law Foundation and Villarreal & LaVoy in their 2010 paper for the Eastern Mineral Law Foundation include detailed, sample participation agreements.

This deal could be documented by checking boxes and filling in blanks in the PA form as described in the following footnote.¹³ The amount of time it would take to complete the agreement would depend on the drafter's familiarity with the PA form, but it should be self-evident that the time spent would be minimal compared with drafting a participation agreement from scratch.¹⁴

What if the terms were to be modified through further negotiation? For example, what if there were three participants instead of one? What if the participants had to carry the prospect generator on the first two wells that were drilled, instead of only the first well? What if the carried interest was limited to costs incurred before casing point election only? Or what if in lieu of a carried interest, the prospect generator was to receive a back-in after payout of 25%? These changes, and more, can be easily made to

the PA form in a matter of minutes by including additional parties and checking other boxes.

At this point, an engaged reader might be raising a multitude of questions and expressing considerable skepticism. What if the prospect had not yet been fully developed and additional seismic is needed? What if the lease block has not been fully put together by the prospect generator? What if the prospect area includes multiple prospects? What if rather than a single prospect generator, the parties wish to form a prospect generating team that will identify prospects then voted on by the participants before commitments to drill are made? What downstream facilities (gathering, gas plant, pipelines) will be needed to produce the prospect and how are such needs addressed by the PA form?

In answer, the PA was designed to address what is believed to be

the most common participation agreement scenario — where a prospect generator who has identified a prospect and put together a lease block that is ready or close to ready to drill is seeking participants to fund the initial test well or wells. If seismic data was utilized in developing the prospect, the assumption is that the seismic data has already been acquired and interpreted.

But if additional seismic and prospect development is needed, the PA form could be attached to an umbrella exploration agreement providing for the acquisition of seismic and leasehold that would then be utilized in developing prospects. The exploration agreement would provide the parameters of a seismic and leasehold acquisition program, with the PA providing for how the costs would be shared and how the prospect generator would be compensated.

13 Boxes checked and blanks filled in hypothetically as follows:

1. Preamble, insert effective date and name/address of Prospect Generator plus County/Parish location of lands and name of Prospect. (Participant's name is on signature page.)
 2. Article II, check boxes of all Exhibits that apply.
 3. Article III, insert names of parties with a 25% working interest credited to the Prospect Generator and 75% working interest credited to the Participant.
 4. Article VI, insert Prospect Buy-In costs and fill in total in blank provided.
 5. Article VI.A, select Option No. 1 (assignment due upon Participant's payment of working interest share of existing lease costs).
 6. Article VI.D, check Option No. 1 (no spud fees).
 7. Article VI.E, leave blank.
 8. Article VII, check box for Prospect Generator's Reserved Overriding Royalty and insert "twenty five percent" and 25% in the blanks.
 9. Article VII, check box for Prospect Generator's Carried Interest and insert "twenty five percent" / 25% in the blanks, plus check Option 2A (Carried Interest includes all drilling and completion costs).
 10. Article VII, select Option No. 1B. Carried Interest applies only to Initial Obligation Well.
 11. Article VII, Additional Promotes, beginning at Article VII.C ignore all text up to Article VIII. Obligation Wells (no Back-In Interests after payout).
 12. Article VIII, Obligation Wells, select Option No. 1, Participant is obligated to participate in the drilling of the Initial Obligation Well only.
 13. Article X, select an option (addresses Wells Proposed by Third Parties).
 14. Article XI, insert name of Operator.
 15. Article XIII, insert "three" and 3 in the blanks for term of AMI.
 16. Article XIII, select Option No. 2 (override does not apply to acquisition of drilling rights).
 17. Article XIV, fill in names, addresses and contact information.
 18. Article XVII, select one of the options for a Tax Partnership. (See discussion in "Practice Pointers" section.)
 19. Article XIX, select Option No. 1 (no arbitration unless agreed)
 20. Article XXI.K, fill in blanks with Texas and courts of Harris County.
 21. Article XXII, fill in three years as term of agreement.
 22. Signature page — Prospect Generator and Participant date and sign the agreement. That would be it. The rest of the text of the PA is mostly definitions and contractual boilerplate.
- 14 Practice Tip: If you download the PA form off the AAPL website, change the page numbers at the bottom which currently refer to page numbers EC-14 thru 49 in an AAPL Executive Committee approval package.

If there is no prospect generator bringing something unique to the table, whether it is a geologic idea, a lease block or an interpreted seismic dataset, then perhaps a joint operating agreement with appropriate modifications would be a better choice than a participation agreement or, alternatively, a joint venture or partnership agreement with a formal management committee and a prospect generating team.

If the PA area is large and multiple prospects are anticipated, the PA form could be set up such that a separate PA applies to each prospect. This could be addressed in Article XXIII, Other Provisions, in the PA form similar to how other provisions are addressed in Article XVI, Other Provisions, of the AAPL JOA form.

If the parties wished to collaborate with a prospect generator in identifying prospects or include

restrictions on proposing prospects that might otherwise trigger sole risk or forfeiture provisions before there is a consensus among the participants to move forward with a drilling program, Article XXIII of the PA form is available to incorporate additional provisions. Downstream provisions could likewise be included in Article XXIII of the PA, though those might be more appropriately included in the JOA form attached to the PA.

It is conceded that the PA form may not fit every conceivable participation deal structure, but the form was designed to cover the most common situations in a manner intended to avoid as many potential questions and issues as possible while still keeping the PA form to a manageable length. In that sense, the project could be likened to the efforts in the 1950s of the landmen, lawyers and others who

helped develop the original AAPL 610 Joint Operating Agreement form. And just as the AAPL 610 Joint Operating Agreement has been amended multiple times through the decades to improve upon its original provisions, the 2022 PA form may see future modifications.

KEY PROVISIONS

Introductory (Articles I-V)

The PA Form begins with a preamble, recitals and definitions. There was considerable discussion within the PADC as to what labels should identify the parties (seller/buyer, promoter/promote, assignor/assignee) with the terms "prospect generator" and "participant" finally agreed upon. The recitals, definitions, exhibits should look familiar to those who work with other similar industry agreements.





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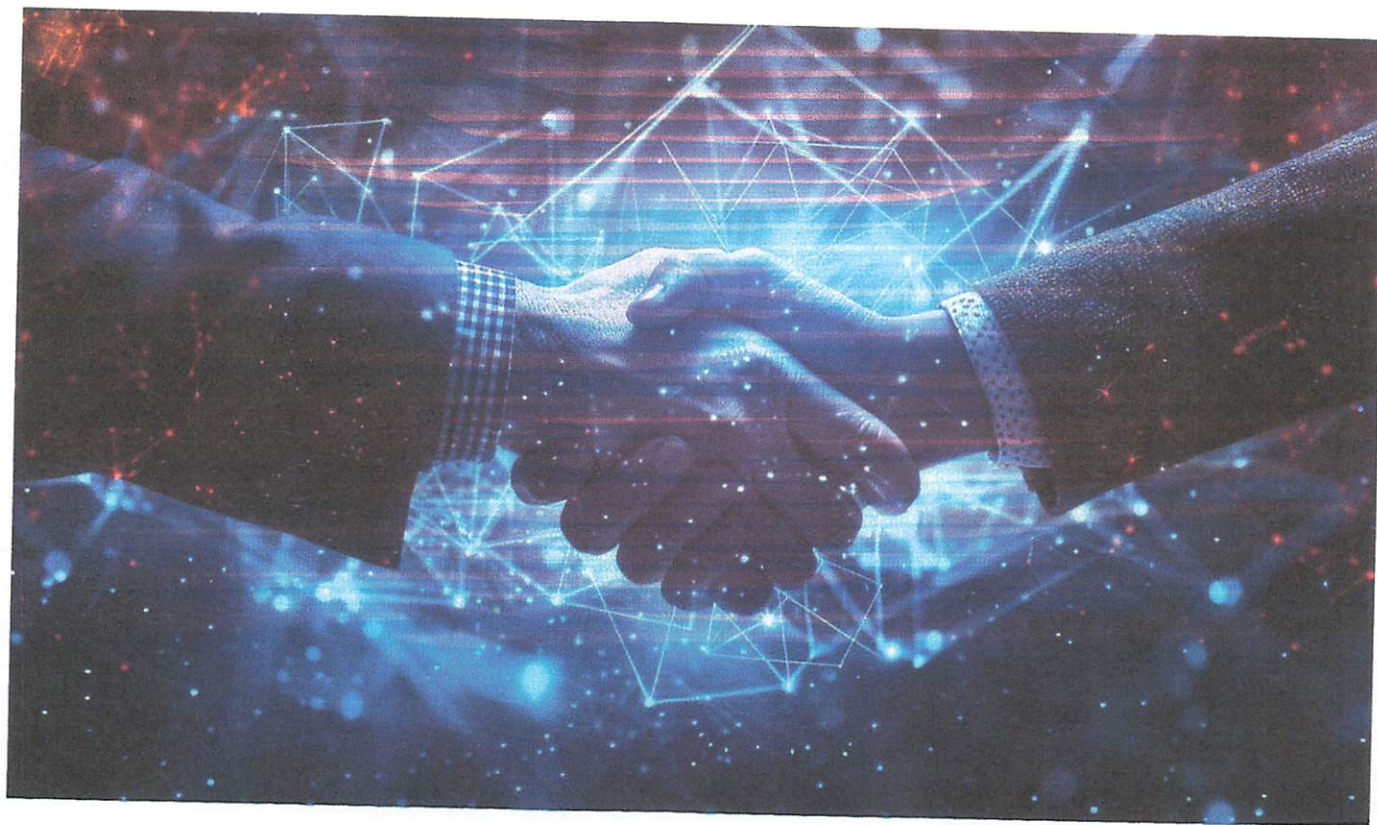
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Article II of the PA form includes the following exhibits:

- A – Description of Prospect Area Lands
- B – List of Existing Leases
- C – AFE for the Initial Obligation Well
- D – Form of Assignment of Oil and Gas Leases
- E – Form of Operating Agreement (including exhibits)
- F – Permitted Encumbrances
- G – Tax Partnership Agreement
- H – List and Description of all Subsequent Obligation Wells
- I – AFEs for all Subsequent Obligation Wells
- J – Other

Article III includes blanks for the insertion of the working interest owners' names and working interest shares for the prospect generator and each participant. Articles IV and V include representations of ownership of existing leases by

the prospect generator with title representations and verification provisions. The net acres and burdens associated with the existing leases are to be reflected on Exhibit B as required by the definition of permitted encumbrances and Article IV, Existing Leases. Article V, Title Representations and Verification, provides for a special warranty of title by, through and under the prospect generator (assignor) but not otherwise. Under Article V the participants verify and accept title to the existing leases and waive claims for adjustment other than for breach of the special warranty of title provided by the prospect generator.

Promote and Obligatory Well Provisions (Articles VI-VIII)

The heart of the agreement is found in Articles VI-VIII. Article VI includes a listing of prospect buy-in costs, including existing leases, geological and geophysical, prospect generation fees, spud fees, legal fees, land costs and other. An invoice for a participant's share of the prospect

buy-in costs is to be submitted to each participant, with payment due at closing.

Article VI.A addresses existing leases and when assignments of the existing leases are due to the participants. Article VI.B addresses G&G costs and licensing. Article VI.C addresses whether an additional prospect generation fee may be due to a third party. Article VI.D addresses spud fees that may be due to the prospect generator or third parties upon commencement of well operations.

Article VII.A provides for an optional reservation of an overriding royalty by the prospect generator. Article VII.B provides for the prospect generator to receive a carried interest in the initial obligation well and possibly subsequent obligation wells, depending on the option selected. Options are provided for the carried interest to be to casing point, through the tanks or otherwise. Also addressed is to which wells the carried interest will apply — the initial obligation well only, a fixed number

of obligation wells, all obligation wells drilled under the PA and possibly even nonobligation wells if Article VII. B. Option No. 5B is selected and the blank filled in.

Article VII.C provides for the optional reservation of a back-in interest after payout by the prospect generator. This could be in lieu of, or in addition to, a carried interest. For example, a prospect generator could reserve a 25% carried interest and no back-in-interest after payout, or a 12.5% carried interest and an additional 12.5% back-in interest after payout. Irrespective, the back-in interest after payout does not apply to carried interests to avoid a double dip.¹⁵

Options 1-4 in Article VII.C.3 provide for the back-in interest after payout to apply to the initial obligation well, a specified number of obligation wells, all obligation wells or an alternative arrangement to be written in, such as all wells, including nonobligation wells. Article VII.C.3 also allows payout to be defined as a percent recovery of drilling and completion costs, such as 100%, 200%, etc. A relatively complex dual option is written into Article VII.C.3, Options 1A and 1B addressing the scenario where a second well is proposed before payout of the initial obligation well.¹⁶

Other options are provided in connection with a back-in interest after payout. Under Article VII.C.4, the options of including or not

including prospect buy-in costs in the payout calculation are provided. Under Article VII.C.6, the options of making prospect generator's election to acquire its back-in interest after payout automatic (option No. 1) or only upon an election made within 60 days of receiving a payout statement (option No. 2) are included.

Under the first paragraph of Article VII.C, unless otherwise stated in the agreement, if the prospect generator backs into a well in which its back-in interest after payout attaches, it is deemed to have relinquished its reserved overriding royalty. If prospect generator does not back into a well with its back-in interest after payout, then under Article VII.C.7, the prospect generator's reserved overriding royalty can either remain the same or be increased. An increase could be accomplished by providing for the override to be calculated on a higher difference between a set percentage and existing burdens, or it could be calculated in another manner (e.g., it could become a fixed percentage in addition to existing Burdens).

Article VIII provides for the initial obligation well and specifies the date on which operations must commence, the surface location and, if a directional or horizontal well, the approximate bottom hole location, and the footage, which may be in vertical feet for a vertical well or measured depth in feet for a

directional or horizontal well. Article VIII also specifies the formation to be drilled and includes a blank for estimated drilling and completion costs as reflected on Exhibit C, the AFE for the initial obligation well.

In addition, Article VIII establishes what subsequent wells are also obligation wells. There can be any number of subsequent obligation wells depending on the option selected. Furthermore, Article VIII provides for consequences for a participant's failure to pay costs when due and a provision for advancement of well costs. There is no nonconsent penalty associated with obligation wells because the participants make a firm commitment to pay their share of costs in all obligation wells when they execute the PA.

Subsequent (Nonobligatory) Wells, the Operator and the Operating Agreement (Articles IX-XII)

Article IX addresses subsequent wells drilled under the JOA, which, unlike the subsequent obligation wells described in Article VIII, are not obligatory. Article X addresses wells proposed by third parties on lands within the prospect area. Article XI designates the operator, and Article XII provides for a joint operating agreement to be attached to the PA that governs day-to-day operations during the drilling of all obligation wells and all subsequent, nonobligatory wells. The PA controls over the JOA.

¹⁵ Per the last sentence of Article VII.C.1, any Back-In After Payout reserved by the Prospect Generator shall not apply to a Carried Interest in a Well or Wells that has previously been reserved by Prospect Generator.

¹⁶ In the event Participants are obligated to participate in the Initial Obligation Well, only, pursuant to either Options 1 or 2 under Article VIII.A, and if Option 1 under Article VII.C.3 is selected such that the Back-In After Payout only applies to the Initial Obligation Well, and if a second well is proposed to be drilled prior to payout of the Initial Obligation Well, then if Option 1A is selected, the Initial Obligation Well shall be deemed to have reached Payout irrespective of whether the Participants had recovered the payout costs inserted in the blanks in Option 1. Prospect Generator must then either participate in or elect to go non-consent in the second well with its after-payout interest subject to whatever non-consent penalty would be applicable under the JOA.

The logic behind Option 1A is that Prospect Generator is being placed in the position of having to make a non-consent election in the second well prior to seeing the full pre-payout production history for the Initial Obligation Well. The acceleration of the payout period in the Initial Obligation Well under VII.C.3, Option 1A serves as a disincentive for the Participants to propose a second well prior to the Initial Obligation Well's payout and as compensation to the Prospect Generator for the loss of an otherwise longer pre-payout production history. Alternatively, if Option VII.C.3, Option 1B is selected, Prospect Generator's Back-In applies after the full recoupment period.

Note: At the time this paper was written a revision of Article VII.C.3 Option No. 1 was being considered to clarify that the Back-In Interest After Payout would not apply to the second well in lieu of the non-consent penalty that would otherwise be applicable under the JOA.

Area of Mutual Interest (Article XIII)

Article XIII establishes an area of mutual interest encompassing the prospect area. Normally the term of the PA should coincide with the term of the AMI. Article XIII also provides options for applying the prospect generator's reserved overriding royalty to leases and other drilling rights acquired with the AMI.

The AMI is set up such that any party has the right to acquire leases or other drilling rights within the AMI area, but the acquiring party must tender an interest in such leases and drilling rights to the other parties subject to payment of their proportionate shares of acquisition costs. The PA does not designate a single party, such as the prospect generator, to handle all AMI acquisitions. The PADC decided allowing any party to make acquisitions within the AMI was preferable due to anticompetitive concerns.

There are several options in Article XIII dealing with the prospect generator's reserved overriding royalty and whether or not it carries over to the acquisition of new leases and drilling rights within the AMI. There are also options addressing the situation where the prospect generator's reserved overriding royalty in a newly acquired lease causes leasehold burdens to exceed what would otherwise be provided for in Article VII.A.

All Other (Articles XIV-Article XXIII)

The remaining articles in the PA address notices, representations and warranties, disclaimers, relationship of the parties, confidentiality, force majeure, arbitration and miscellaneous topics, all of which are typical of the contractual "boilerplate" found frequently in participation agreements. Article XXII establishes the term of the PA, which, as already noted, should coincide with the term of the AMI established in Article XIII.

PRACTICE POINTERS**Read the Agreement; Use Checklists**

The first and most important practice pointer is to become familiar with the PA form before using it. Though the PA form is 35 letter-size pages, much of it is blanks to be filled in and boxes to be checked depending on the options selected. Regardless, the PA form is a relatively quick read when compared, for example, with the AAPL Model Form Joint Operating Agreement.

Most if not all of the common features of a basic participation agreement are included in the various options in the PA form. So the PA form is itself a checklist that can be used in thinking through issues and formulating deal terms. Beyond that, two of the papers cited earlier, written by Karen Lynch¹⁷ and Alan Cummings,¹⁸ incorporate detailed checklists for negotiating participation agreements. Lynch's paper deals more with seismic agreements, while Cummings' paper addresses exploration agreements¹⁹ more generally.

Both of these papers are excellent, and their checklists are comprehensive, thoughtful, and as relevant to participation agreements today as they were when the papers were written in 1997 and 2004. Studying the PA form simultaneously with the checklists provided by Lynch and Cummings is a good way to achieve further understanding of participation agreements and is likely to stimulate more careful thought in selecting options and considering additional provisions for the PA form.

Classification and Transparency of Prospect Buy-in Costs

Article VI of the PA provides for a detailed breakdown of the most common prospect buy-in costs. The PADC believed it was important

to segregate these costs since the costs can be treated differently on a participant's tax return, and it can be difficult to get such cost breakdowns from a prospect generator many months after a PA is signed.

It is common for prospect buy-in costs to be in excess of what the prospect generator has actually invested in leases, G&G and so forth. Amounts included in the prospect buy-in costs that are in excess of the actual amounts invested by the prospect generator are generally to compensate the prospect generator for time, salaries and expenses incurred by the prospect generator as well as the time value of money and risks that have been incurred.

Nevertheless, it is not unreasonable to ask a prospect generator how much of a "promote" is included in prospect buy-in costs. As with anything else in the PA, the promote included in prospect buy-in costs can be a matter of negotiation.

Tax Partnerships

Consider whether a tax partnership is to be included, or not, as an exhibit to the PA. The options to include, or not, a tax partnership are addressed in Article XVII of the PA. A detailed discussion of tax partnerships is beyond the scope of this article, but in very general terms, a tax partnership is usually appropriate where carried interests are involved and one party is paying a disproportionate share of drilling and completion costs. Not having a tax partnership when carried interests are involved can jeopardize a party's eligibility to deduct its full share of the intangible drilling costs incurred in obligatory wells on its tax return.

But tax partnerships are administratively expensive to set up and maintain with annual partnership tax filings and so forth and will likely require the involvement of a professional accounting firm. So the

17 Lynch, *supra* note 11.

18 Cummings, *supra* note 10.

19 Also known as participation agreements, though Cummings does not call them that.

question becomes, are they worth it? The answer to that question may depend on the number of wells in which a disproportionate sharing of costs will occur. Professional tax advice should be sought in making the determination as to whether a tax partnership would be beneficial.

AMI Issues

Having a term limit on the area of mutual interest is desirable for several reasons, including avoiding potential violations of the rule against perpetuities. The term of the AMI should never exceed the term of the PA itself, or at least it should not without adding a special provision that the AMI survives the term of the PA.

The AMI provision in Article XIII addresses acquisitions of drilling rights within the AMI, which, per the definitions section in the PA, includes oil and gas leases, farmins, mineral acquisitions and other operating rights. But what if an oil and gas lease, for example, covers land both inside and outside the AMI? Article XIII as written would only cover the portion of the lease in the AMI.

Excluding outside acres from leases partially within and outside the AMI is one way of handling it, but that necessitates an allocation of costs between the portion of the lease falling outside of the AMI and the portion within the AMI. Will the allocation be accomplished on a per-acre basis or by using another yardstick, such as an estimate of oil and gas reserves in place? Basing the allocation on per-acre bonus paid may be the most expedient way of handling the allocation, but if the lease purchased includes proven reserves outside the AMI, the allocation to undeveloped acreage within the AMI could be inflated.

Alternatively, outside acreage could be covered by the AMI through the addition of a special provision in Article XXIII, but that could also

raise issues. For example, what if the portion of the lease within the AMI is minimal? A participant would nevertheless have to participate in the entire acquisition or else forfeit its interest in a newly acquired lease covering lands in the AMI. If the portion of the lease outside the AMI is offered to and acquired by the participants, it is recommended that the AMI area be amended to include the outside acreage.

Form Assignment

Exhibit D to the PA is a Form Assignment of Oil and Gas Lease. The assignment form will of necessity be deal specific and cannot be drafted until after the parties have agreed on the options included in the PA form. The assignment is an important document for constructive notice purposes since the PA is normally not recorded.²⁰ When drafting the assignment, care should be taken to ensure that it follows the PA. For example, no title warranties are provided by the PA, except for the special warranty of title from the prospect generator provided for in Article V. So unless otherwise changed by the PA, the assignment, likewise, should provide for only a special warranty of title by, through and under the prospect generator as the assignor. Proportionate reduction clauses are also important and should be included in the assignment even though the PA form itself does not address proportionate reduction.

Buyer Beware of Title Issues

Though specific net acre information and disclosure of all burdens in connection with existing leases must be included in Exhibit B to the PA, Article V specifies that participants verify and accept title to the existing leases and waive any claims for adjustment other than for breach of the special warranty of title provided by the prospect generator. Furthermore, under Article

XVI.B, participants accept title to the existing leases "as is." This suggests that prospective participants need to be "buyer beware" regarding title, especially since the prospect generator is likely to be carried in one or more obligation wells and thus lacks the same degree of "skin in the game" as the participants when it comes to title.

TOOL FOR FUTURE OPPORTUNITIES

As noted, there is skepticism among some lawyers and landmen about using standardized forms when it comes to participation agreements, perhaps even more so today now that computers utilizing artificial intelligence can create customized contracts and agreements specific for each transaction. AI aside, modern, computerized, cloud-based word processing has made reliance on printed standardized forms in the upstream oil and gas sector increasingly obsolete. One need look no further than the widespread replacement of the printed Producers 88 oil and gas lease form with customized forms as an example of the decline in usage of standardized forms within the upstream oil and gas industry.

Nevertheless, standardized forms will reduce time spent negotiating and documenting transactions. What would the oil and gas industry be like if the AAPL Form Operating Agreement had never been introduced and each company still used its own operating agreement form necessitating a lengthy negotiation each time a joint well is proposed? Even then, there has been a decline in usage of the AAPL Form Operating Agreement as parties, especially outside Texas, increasingly rely on forced pooling orders, or even common law co-tenancy rules, instead of taking the time and trouble to negotiate a joint operating agreement. This trend further

20 If the PA covers lands in Texas, an excellent set of assignment forms can be found in Volume 7, Chapter 10, Lease Transfers of West's Texas Forms, Fourth Edition (Thompson West 2008), by Midland, Texas oil and gas lawyer William B. Burford. The chapter is updated annually.

demonstrates the erosion of standardized forms within the upstream oil and gas industry.

A question that can be raised about participation agreements more generally is how relevant are they today when so much of U.S. drilling is in shale plays where geologic considerations are often secondary to cost and technological feasibility? Are prospect generators really needed in mature shale basins? Industry mergers and acquisitions are leading to the consolidation of large blocks of leases in the Permian Basin and elsewhere by major oil companies and large independents, making it ever more difficult for prospect generators to assemble large lease blocks. Plus, climate concerns and anti-fossil fuel sentiment in the U.S. appear here to stay. So are prospect generators and participation agreements fading into the sunset?

These are fair questions. Nevertheless, until U.S. oil and gas resources are substantially depleted, or substantially replaced by renewable energy sources, the need for robust oil and gas exploration and development in the U.S. is anticipated to continue.²¹ And with such continued oil and gas exploration and development will invariably come

opportunities to put together new lease blocks and test new or refined geologic concepts through participation agreements. It is hoped that the new AAPL Model Form Participation Agreement will help facilitate such opportunities. ▲

ABOUT THE AUTHOR

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21 Robert Bryce, *What the Media Won't Tell You About the Energy Transition: The hype, and the reality about the energy transition in ten charts*, (May 7, 2024), robertbryce.substack.com/p/what-media-wont-tell-you-about-energy-transition

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