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Yours, Mine, and Ours: Documenting the Exploration Venture

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I.
Introduction

The business of exploring for oil and gas is unquestionably one of the most exciting businesses around. Many factors contribute to this excitement, but perhaps the greatest single factor is that the oil and gas explorationist's main competition is mother nature. From the origination of the prospect idea, to the drilling of the initial well to test the idea, geologists, geophysicists and engineers pool their collective talents in an effort to "outsmart" mother nature and get her to share some of the energy resources that we need to sustain our world economy. Although technological advances have helped improve our industry's drilling success rate, the exploration business remains an always challenging and sometimes cruel business that is not for the faint of heart.

Most E&P companies attempt to manage this "exploration risk" in two ways. First, the companies hire the most talented people they can find and equip them with the most advanced exploration tools they can afford. Without a doubt, the most important ingredient for success in the E&P business is having a creative group of "exploration minded" people that work together as a team to generate exploration opportunities. The second method E&P companies use to deal with exploration risk is to establish an exploration venture and share the risk with one or more other parties. This paper will focus on this second risk management technique and discuss some of the basic considerations that go into documenting the exploration venture.

II.
The Exploration Venture

The term "exploration venture" means different things to different people. When I use this term, I intend for it to include any association or common enterprise between two or more persons that is formed for the joint exploration and development of lands that are believed to be prospective for oil and gas exploration.

A. The Project Entity. The exploration venture may take the form of a separate legal entity (the "Project Entity") that is created for the sole purpose of conducting the joint exploration and development activities. Under this type of arrangement, the newly formed Project Entity (*e.g.* General Partnership, Limited Partnership or Limited Liability Company) owns the venture's assets and the participants in the venture own an equity interest in the Project Entity. Each Project Entity agreement (*e.g.* Partnership Agreement, Limited Partnership Agreement or LLC Operating Agreement) contains provisions that set forth (i) the ownership interests of each participant, (ii) each participant's obligation to contribute capital to the venture, (iii) the method by which the participants will manage the venture's activities, (iv) the allocation of income, expenses, deductions and credits among the participants, (v) the events that will cause the dissolution, termination and liquidation of the Project Entity, (vi) the intended income tax treatment of the venture's activities and (vii) various other matters relating to the administration of the Project Entity's affairs. Since this ownership structure can impose significant limitations on a participant's ability to assign, pledge or otherwise dispose of its interest in the venture, its use is usually limited to those situations where special tax considerations (*e.g.* special allocations of deductions or credits) or participant considerations (multiple individual investors) dictate that a separate legal entity be created.

B. The E&P Agreement. The exploration venture can also take the form of a common enterprise that is bound together by contractual commitments, but is not a separate legal entity. Under this type of arrangement, the ownership of, or the right to acquire an ownership interest in, the venture's assets is vested directly in each participant. The participants then enter into a contractual agreement (an "E&P Agreement") that sets forth the respective rights and obligations of the participants with respect to the joint exploration and development of the venture's assets. The remainder of this paper will focus on the documentation of three types of E&P Agreement: the Exploration Agreement, the Participation Agreement and the Farmout Agreement.

III.
Defining the E&P Agreement

Before discussing the basic considerations that go into documenting these three types of E&P Agreements, it is first necessary to establish a common definition for each of the three agreements. I must caution you that the following definitions are based solely on the author's experience in preparing these types of agreements and the arbitrary conventions I have used to distinguish between the three agreements may differ from those of other oil and gas practitioners.

When I use the term "**Exploration Agreement**", I am referring to a joint exploration and development contract that covers a large amount of acreage that requires a significant amount of exploration activity (*e.g.* 3-D or 2-D seismic survey, magnetic survey and/or geochemical survey) before the participants can identify prospects and drill wells on such acreage. The term "**Participation Agreement**" refers to a joint exploration and development contract that covers one or more defined prospects that are "drill bit ready" (*i.e.* no significant exploration activity is required before the initial test well is drilled). The term "**Farmout Agreement**" refers to a contract by which one party (the farmor) agrees to assign all or a portion of its oil and gas rights in certain acreage to another party (the farmee) in exchange for the performance of certain obligations (usually including the drilling of one or more wells) by the farmee. For convenience, I will sometimes refer to the Exploration Agreement, the Participation Agreement and the Farmout Agreement collectively as the "**E&P Agreement**".

IV.
Common Contractual Considerations

While each E&P Agreement has its own special drafting considerations, there are several contract issues that are common to all of these agreements. Some of these issues are discussed below.

A. Contract Formation. The only thing worse than having a business deal fall through because the parties cannot agree on the contract terms, is having a dispute with the other party over whether a contract exists or not. The legal analysis of contract formation is relatively straight forward (Has there been an offer? If so, has the offer been accepted?). However, the line between "preliminary negotiations" and "offer and acceptance" can often be blurred by the actions of the parties during negotiations (*e.g.* when one party detrimentally relies on the promises or actions of the other party). The issue is further complicated in those jurisdictions that readily impose an obligation on each party to "negotiate the contract in good faith".

The easiest way to avoid this problem is to prepare a term sheet or letter of intent early in the negotiation process that contains clear and unequivocal language negating any inference that a binding contract is intended to be formed prior to the execution of a definitive E&P Agreement. The following are examples of language that could be used in a term sheet or a letter of intent to avoid the "unintended contract".

Example 1:

This term sheet sets forth the basic terms and conditions under which Arbuckle Exploration Company ("Arbuckle") is willing to participate with Drysdale Exploration Company ("Drysdale") in the joint exploration and development of the Program Area and is being submitted for discussion purposes only. This term sheet, even if accepted by Drysdale, shall not create any obligation on the part of either Arbuckle or Drysdale to consummate the transaction described herein. Neither Arbuckle nor Drysdale shall have any obligation with respect to the subject matter of this term sheet unless and until the parties execute a definitive Exploration Agreement incorporating the terms hereof.

Example 2:

Upon execution of this letter of intent, the parties agree to undertake, diligently and in good faith, to devote such time and resources as are reasonably necessary to prepare, negotiate and execute the Definitive Agreement by _________, 2005. If the Definitive Agreement has not been executed by the parties on or before ________, 2005, then this letter of intent shall terminate and no party shall thereafter have any further rights or claims against, or obligations to, any other party. For the period commencing with the execution of this letter of intent and ending on __________, 2005,

Seller agrees that it shall not, directly or indirectly, encourage, solicit or entertain any other offers, inquiries or proposals for, or engage in any discussions with respect to, the acquisition of the Subject Assets.

Except for the covenants contained in the immediately preceding paragraph, this letter of intent, even if accepted by Seller, shall not constitute a binding obligation on the part of either Seller or Buyer and no such obligation shall arise until the execution of the Definitive Agreement.

B. Statute of Frauds. Since each E&P Agreement is a contract that "covers interests in real property", the Statute of Frauds requires that each such contract (i) be in writing, (ii) contain the essential terms of the parties' agreement, (iii) contain an adequate legal description of the lands that are the subject of the contract and (iv) be executed by the party against whom enforcement of the contract is sought. It has been this author's experience that, of these four (4) requirements, the one that presents the most problems is the requirement that the contract contain a valid legal description.

While use of maps or plats as exhibits are helpful in identifying the lands covered by the E&P Agreement, they should not be used as a substitute for a valid legal description. For a description to be a "valid legal description" under the Statute of Frauds, it must describe the land in sufficient detail so it can be identified and located on the ground. The three most common types of legal description are (i) the government survey (*i.e.* Township and Range), (ii) a metes and bounds description and (iii) a recorded subdivision plat.

C. The Parties—Capacity to Execute/Ability to Perform. Each party to the E&P Agreement should be adequately identified and the authority of the individual executing the agreement on behalf of each such party should be verified. If a party is a corporation or limited liability company, determine the state of incorporation/organization and what authorized officer/representative will sign the E&P Agreement on behalf of such party (*e.g.* President, Vice President, Member, Attorney-in-Fact). Any person that is executing as "Attorney-in-Fact" should provide a copy of the Power of Attorney under which such person is given authority to execute the document. If a party is a general partnership, all partners must execute the E&P Agreement unless documentary proof of authority to execute on behalf of the partnership is obtained to the contrary. If a party is a limited partnership, an authorized officer of the general partner must execute the E&P Agreement. If a party is a fiduciary (executors, administrators, guardians, trustee), determine such party's power to contract and the capacity in which such party will execute the E&P Agreement. With respect to individuals, some states require the joinder of the wife for a contract to be binding.

One should also assess each party's ability to perform its obligations under the E&P Agreement. While requiring the advance payment of all joint operation costs can alleviate many concerns, it cannot solve all of the problems associated with a party's inability or refusal to comply with the terms of the E&P Agreement. This is especially true in the context of a bankruptcy. If a party does not have a substantial balance sheet, consideration should be given to requiring such party to provide additional credit support for its obligations (*e.g.* parent guaranty or letter of credit).

D. Recording Statute Considerations. There are several areas in the E&P Agreement (as well as the Operating Agreement that is attached as an exhibit thereto) that directly affect, or have the potential for affecting, each party's rights in the underlying oil and gas interests. Examples of some of these areas are:

1. The contractual right to receive an assignment of oil and gas interests upon the occurrence of some "triggering event";

2. An agreement to maintain *legal title* to oil and gas interests in the name of one party for the benefit of the other party or parties to the E&P Agreement;

3. Working interest percentages and/or net revenue interest percentages that are different from record title ownership because of non-consent operations, carried working interests or other provisions of the E&P Agreement;

4. The creation of liens to secure the obligation of each party to pay its share of the costs incurred in conducting joint operations;

5. Restrictions on the assignability of a party's ownership interest in the underlying oil and gas interests; and

6. Preferential purchase rights.

Since each of these provisions has the potential for impacting a party's record title interest, strong consideration should be given to recording a memorandum of the E&P Agreement. A recorded memorandum will give third parties constructive notice of the E&P Agreement and the "real property" provisions contained therein. This should prevent any third party assignee from successfully asserting bona fide purchaser status in an effort to avoid the effect of these provisions. Recording a memorandum of the E&P Agreement can also be helpful in the context of a bankruptcy filed by a party to the E&P Agreement, since the trustee in bankruptcy has the "avoidance power" of a bona fide purchaser.

E. Words to Use/Words to Avoid. One of the more difficult things to convince a client is that the use of certain words in the E&P Agreement can have profound and unintended consequences. For example, using the word "partner" to describe the parties to an E&P Agreement or using the word "partnership" to describe the relationship between the parties to an E&P Agreement could result in the establishment of both joint and several liability and fiduciary duties among the parties. Problems can also arise when the client insists on using certain terms in the E&P Agreement because "everyone knows what they mean". Relying on custom and usage to define what a party intends in a contract is not recommended.

One of the best ways to make an E&P Agreement both easier to read and more accurately reflect the parties' intent is to use defined terms. Whether the defined terms are set out at the beginning of the agreement or are defined in the text of the agreement doesn't really matter. However, if you decide to define the terms in the text of the agreement, you may want to include, either at the beginning of the agreement or in an exhibit, a list of the defined terms with a reference to the section in which it is defined. An example of some defined terms that I have found useful in preparing E&P Agreements are set forth below.

"Accounting Procedure" shall mean the COPAS Accounting Procedure for Joint Operations attached as Exhibit C to the Operating Agreement.

"AFE" shall mean an authority for expenditure that is prepared by a party to this Agreement in connection with a proposal to conduct an operation or activity hereunder, which authority for expenditure shall be in the form attached hereto as Exhibit __ or a comparable form setting forth substantially the same information.

"Affiliate" shall mean, with respect to another entity, any entity directly or indirectly controlling, controlled by or under common control with such other entity; for the purpose of this definition, "control" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of an entity, whether through the ownership of voting securities, the ownership of general partnership interests in a partnership or otherwise.

"Drilling Costs" shall mean all costs incurred in connection with the drilling, deepening, reentering, sidetracking, plugging back, testing, completing, recompleting and equipping of a well and the plugging and abandoning of a well drilled as a dry hole. This term includes, but is not limited to, (i) all title examination expenses, title curative costs, surveying costs, costs of pits, roads, water wells and water disposal wells and the cost of all site construction activities; (ii) all costs incurred for the settlement of damage claims and the costs of restoring the well site in accordance with applicable governmental and/or lease requirements; and (iii) all costs (including overhead charges) that are chargeable to a working interest owner under the Accounting Procedure in connection with any of the operations or activities described above.

"Easements" shall mean (i) all easements, rights-of-way, surface leases, licenses or servitudes over lands in the vicinity of the Program Area that are now owned or are hereafter acquired by Operator for ingress to and egress from the Program Area, and (ii) all easements, rights-of-way, surface leases, licenses or servitudes for production facilities, gas gathering lines, water disposal facilities and other systems or facilities that are used in connection with the exploration, development, operation or maintenance of the Program Area.

"Gross Proceeds" shall mean, with respect to a particular well, the gross amounts received from the sale of all Hydrocarbons produced, saved and sold from such well, subject to the following:

(i) If a controversy or possible controversy exists (whether by reason of any statute, order, decree, rule, regulation, contract or otherwise) between the seller of production and any purchaser thereof as to the correct sales price of any such production, then any amounts withheld by such purchaser or deposited by it with an escrow agent shall not be considered received by the seller of production until actually collected by such seller,

but the amounts received by the seller shall include any interest, penalty, or other similar amount paid to the seller in respect thereof;

(ii) All Hydrocarbon production that is vented, flared or unavoidably lost or used by Operator in accordance with prudent practices for drilling, production and other field operations shall be excluded from this definition;

(iii) Amounts received by the seller of production as a loan from a purchaser of such Hydrocarbon production, whether with or without interest, shall not be considered to be derived from the sale of such Hydrocarbon production, but proceeds of sale applied to repayment of any such loan shall be considered proceeds of sale of Hydrocarbon production; and

(iv) Cash settlements and cash make-ups received by an underproduced party under gas balancing or similar agreements shall be considered derived from the sale of Hydrocarbon production.

"Hydrocarbon" or "Hydrocarbons" shall mean oil, gas (including, without limitation, methane, ethane, propane, coalseam methane gas, coalbed gas, and all other forms of gas produced from coal seams, coal beds, shales or carbonaceous shales), and all other liquid and gaseous hydrocarbons.

"Leases" shall mean those oil and gas leases more particularly described on Exhibit __ attached hereto, together with any substitutions or replacements therefore, and any additional oil and gas leases that may be hereafter acquired by Operator within the Program Area.

"Lease Acquisition Costs" shall mean all direct costs and expenses incurred by a party in connection with the acquisition of a Lease, including, without limitation, bonus consideration, paid-up delay rentals, lease broker fees and expenses, legal fees, recording fees, the cost of obtaining title curative material and related expenses.

"Lease Maintenance Costs" shall mean all delay rental payments, shut-in royalty payments, minimum royalty payments and other costs necessary to maintain a Lease in force and effect, specifically excluding, however, Drilling Costs, Operating Costs and Production Costs.

"Operating Costs" shall mean (i) all costs and expenses incurred in producing and marketing Hydrocarbons from producing wells covered by this Agreement, (ii) all costs and expenses incurred in operating, maintaining and repairing such wells and all related surface facilities necessary to dispose of water and to produce, treat, gather, compress and market Hydrocarbons from such wells and (iii) all other costs and expenses (including overhead charges) that are incurred in the ongoing operation and maintenance of the Hydrocarbon properties covered by this Agreement and that are chargeable to a working interest owner under the Accounting Procedure. Operating Costs shall not include Drilling Costs, Lease Maintenance Costs or Production Costs.

"Payout" shall mean, with respect to a particular well, that point in time when the Gross Proceeds attributable to such well (after deducting all Production Costs and Lease Maintenance Costs allocable to such well) equals the sum of (i) all Drilling Costs incurred in connection with such well and (ii) all Operating Costs incurred or accrued in connection with the operation of such well during the period of recovery (*i.e.* the payout period).

"Permitted Encumbrances" shall mean (i) the terms, restrictions, reservations and other matters contained in or referred to in the Leases and the Operating Agreement; (ii) lessors' royalties, overriding royalties, net profits interests, reversionary interests and similar burdens that do not operate to reduce ________'s net revenue interest in the Leases to less than ________ percent (__%) for each such Lease; (iii) tax, operators', mechanics', materialmen's, contractors' and similar statutory liens securing obligations not yet due; (iv) any liens or security interests created by law or reserved in the Leases for royalty, bonus or rentals or for compliance with the terms of the Leases; (v) any obligation or duties affecting the Leases to any municipality or public authority with respect to any franchise, grant, license or permit, and all applicable laws, rules and orders of governmental authorities; (vi) required third party consents to assignments and similar agreements with respect to which waivers or consents are obtained from the appropriate parties; and (vii) all rights to consent by, required notices to, filings with, or other actions by governmental authorities in connection with the sale or conveyance of the Leases or interests therein if the same are customarily obtained contemporaneously with or subsequent to such sale or conveyance.

"Person" shall mean any individual, corporation, association, partnership, trust, governmental entity or other organization.

"Prospect Area" shall mean an area that reasonably appears prospective for oil and/or gas exploration, as defined by subsurface structures, stratigraphic traps, faults, water contracts and other productive limits. Unless otherwise agreed by all the parties, each Prospect Area shall contain no more than _________ (__) contiguous surface acres and shall be limited to those depths from the surface to the base of the deepest objective formation in the Prospect Area.

"Production Costs" shall mean (i) all production, severance, excise, windfall profits, ad valorem, property, occupation and other taxes (other than income and franchise taxes) imposed on the ownership or production of Hydrocarbons from the Program Area, (ii) all royalties, overriding royalties, production payments, carried interests, net profits interests and other burdens to which the Leases were subject on the Effective Date and (iii) any amounts paid as a refund, interest or penalty to a purchaser of Hydrocarbon production because the amount initially received by the seller of such production was more, or allegedly more, than permitted by the terms of any applicable contract, statute, regulation, order, decree or other obligation.

"Program Area" shall mean the lands described on Exhibit __ attached hereto.

"Test Well" shall mean the initial well that is to be drilled to test a proposed Prospect Area.

F. The Operating Agreement. Every E&P Agreement I have ever worked on has had some version of the A.A.P.L. Form 610 Model Form Operating Agreement (the "Operating Agreement") attached to it as an Exhibit. While an in depth analysis of the Operating Agreement is beyond the scope of this paper, I would like to touch on a few issues that should be considered when integrating the terms of an Exploration Agreement with the terms of the Operating Agreement.

1. Effective Time. It is not uncommon for an E&P Agreement to provide that one or more parties will not be required to pay any portion of the cost of joint operations until some future time, such as "casing point" or completion of the initial well. It is also not uncommon for the parties to assume under such circumstances that the Operating Agreement need not apply until casing point is reached or the initial well is completed, as the case may be. However, this erroneous assumption could result in the parties to the joint operations being classified as a "mining partnership", whereupon each party would become jointly and severally liable for the cost of the operation. The reason for this is that the language expressly disclaiming the creation of a mining partnership (and joint liability) is contained in the Operating Agreement. Therefore, to avoid being classified as a mining partnership, either (i) the Operating Agreement should become effective immediately or (ii) the E&P Agreement should contain the same "joint liability disclaimer" language that is found in the Operating Agreement.

2. Coordination of Agreements. It is very important to coordinate the terms and provisions of the Operating Agreement with the terms and provisions of the E&P Agreement. The potential for conflict between the two agreements is often increased by the parties' tendency to use the Operating Agreement for situations it is not designed to cover. Many of these potential conflicts (*e.g.* Contract Area vs. Program Area/Farmout Area; Interests of Parties; Subsequent Operations; Maintenance of Uniform Interest) can be avoided by making a clear distinction between (i) the geographic area covered by the E&P Agreement (*i.e.* the Program Area/Farmout Area) and (ii) the geographic area covered by the Operating Agreement (*i.e.* the Prospect Area/Contract Area). This can be accomplished by providing in the E&P Agreement that the Program Area/Farmout Area is comprised of (or has the potential of being comprised of) several different Prospect Areas/Contract Areas, each of which shall be governed by its own separate Operating Agreement. Those additional areas where conflicts usually arise (Definitions; Titles; Management of Operations; Limitation of Expenditures; Other Operations) can be addressed in Article XV (Other Provisions) of the Operating Agreement.

In an "ideal world", these modifications would result in the two agreements working together without any conflict. However, since we live in the "real world" (at least most of us), language should be added to either the E&P Agreement or the Operating Agreement that specifically provides that if any conflict arises between the terms of the E&P Agreement and the terms of the Operating Agreement, the terms of the E&P Agreement shall prevail.

3. Article XV (Other Provisions). The number of "Other Provisions" that are routinely added to Article XV of the Model Form Operating Agreement (A.A.P.L. Form 610-1982) has grown significantly over the years. While these provisions cover a variety of issues, they can all be classified as one of two types. The first type of provision is designed to correct a perceived deficiency in the way the Model Form Operating Agreement addresses, or fails to address, an issue that is common to most joint operations. Some examples of these types of provisions are: (i) Sequence of Operations (modifying Article VII.D.); (ii) Participation in Subsequent Operations (modifying Article VI.B.); (iii) Advance Payment and Non-Payment of Costs (modifying Article VII.); (iv) Other Operations (modifying Article VII.D.3.); (v) Required Operations (modifying Article VI.B.2.); and (vi) Memorandum of Operating Agreement.

The second type of provision is designed to address those issues that arise when the Model Form Operating Agreement is (i) integrated with an E&P Agreement (as discussed in Section F.2. above), (ii) used in a jurisdiction with "special operational considerations", or (iii) utilized for certain types of "special joint operations" not originally contemplated by the Model Form Operating Agreement (*e.g.* unconventional wells, horizontal wells, etc.). Set forth on Appendix A to this paper are some examples of provisions that might be added to Article XV of the Model Form Operating Agreement in connection with an unconventional gas project in Arkansas. Of course, this list of provisions is intended to supplement the "other provisions" described in the preceding paragraph.

V.
Documenting the E&P Agreement

The following checklists identify some of the issues (in addition to those identified in Article IV above) that should be considered when negotiating an Exploration, Participation or Farmout Agreement. Since the Exploration and Participation Agreements have many common characteristics, I have created one checklist for both Agreements. Where there are significant differences between the two Agreements, such differences have been identified. These checklists are not intended to be all inclusive. However, they should help identify most of the important issues that must be addressed in an E&P Agreement.

A. Exploration/Participation Agreements.

1. Description of Lands Covered.

(a) An Exploration Agreement usually covers a large area of land that the company believes is prospective for oil and gas production (the "Program Area"). Since the Program Area is so large, it is often not feasible (or even desirable) to acquire oil and gas leases (the "Leases") over the entire Program Area before the Exploration Agreement is executed. Therefore, in order to provide a valid legal description of the Program Area, it is necessary for the boundary of the Program Area to follow government survey lines (*i.e.* Section, Township and Range) or some other natural or man-made boundary (*i.e.* survey lines or subdivision plats) so that the Program Area can be "identified and located on the ground".

(b) As the exploration work progresses under the Exploration Agreement, the parties will identify prospects and allocate portions of the Program Area to such prospects ("Prospect Areas"). Each Prospect Area must be identified in the manner described in (a) above.

(c) Since Participation Agreements are (by definition) "drill bit ready", there are usually two acceptable alternatives for describing the lands covered by the Participation Agreement (the "Project Acreage"). The first is to provide a legal description of all of the lands included within the Project Acreage. The second alternative, and by far the most common, is to describe the Leases that are included within the Project Acreage (the "Project Leases") in an Exhibit to the Participation Agreement. To satisfy the Statute of Frauds, this Exhibit must include the recording information for each of the Project Leases.

2. Interest of the Parties.

(a) Each party's participation interest in the Program Area should be clearly set forth in the Exploration Agreement. In many situations, it will be desirable to describe each party's percentage interest in a schedule or table that is attached as an Exhibit to the Exploration Agreement. This is especially true if there are any carried interests or other cost sharing arrangements that require certain parties to pay more than their "ownership percentage" share of the cost of conducting operations on the Program Area (the "Program Area Costs").

(b) If there is a disproportionate sharing of Program Area Costs (*e.g.* carried interest), what Program Area Costs are included in the "carry"? If there are cost overruns, is the carried interest subject to a cap?

(c) Under a Participation Agreement, the Project Leases have already been identified. Therefore, the description of each party's interest in the Project Acreage should include both the working interest percentage and the net revenue interest percentage.

(d) Many Participation Agreements provide for the "prospect generating company" to receive a carried working interest in one or more wells drilled on the Project Acreage. Does this carried interest include all costs incurred through "casing point" or through completion of the well? If the carry applies through completion of the well, what does completion mean? Does it include all costs of completing and equipping the well "through the tanks" (including the cost of all flow lines up to and including the wellhead check meter)?

(e) Will the carried interest apply to any substitute well that is drilled in replacement of the original "carried well"? If so, is the carried interest in the substitute well subject to a cap?

3. Exploration Data. Most Exploration Agreements contemplate that the parties will acquire seismic data (either through purchase of existing data or through conducting a new seismic survey) and utilize such seismic data in the identification of prospects within the Program Area. The following are some issues to consider in connection with the acquisition, ownership and utilization of such seismic data.

(a) If the seismic data is to be acquired by conducting a new geophysical survey over the Program Area (the "Geophysical Survey"), what are the technical parameters of the Geophysical Survey? Have all parties had an opportunity to review, comment on and approve these parameters? If possible, the scope, design and other parameters of the Geophysical Survey should be set forth in an Exhibit to the Exploration Agreement.

(b) What are the terms of the Seismic Contract with the company that will shoot the Geophysical Survey? Will all parties to the Exploration Agreement execute the Seismic Contract or will they severally agree in the Exploration Agreement to be bound by its terms? Has provision been made for each party to receive a license to the data resulting from the Geophysical Survey (the "Program Data")? For a party to be able to take possession of the Program Data, "work" the Program Data on its own workstation and/or have it reprocessed, it will be necessary for such party to receive a separate license to use the Program Data.

(c) If the seismic data is to be purchased, the data license will usually provide that each party to the Exploration Agreement must obtain its own license in order to receive a copy of the data. The data license should be reviewed to determine what restrictions are imposed on each licensee's right to use the seismic data and to disclose or transfer it to third parties.

(d) Will the parties conduct any exploration activities in addition to those contemplated by the Geophysical Survey (*e.g.* additional seismic acquisition or processing work, magnetic surveys, geochemical surveys, etc.)? If so, are all parties required to join in such additional exploration activities? How will the additional data be owned?

(e) The parties to the Exploration Agreement should be entitled to disclose the Program Data to certain third parties (*e.g.* consultants, potential purchasers, etc.). What limitations will be imposed on a party's right to disclose the Program Data to third parties? Will such third parties be required to execute a Confidentiality and Non-Competition Agreement?

(f) Will a party have the right to sell an interest in the Program Data? If there is a general prohibition on the transfer of Program Data, what exceptions (if any) should there be to such prohibition? What about transfers to affiliates, transfers by merger, reorganization or consolidation, transfers to third parties acquiring an interest in the Program Area, or transfers in connection with a financing transaction.

4. <u>Program Area Operator</u>.

(a) Will management of Program Area operations be handled in the same manner as the Prospect Area operations under the Operating Agreement? If so, who will be responsible for conducting/managing the exploration activities on the Program Area (the "Program Operator")? How is the Program Operator to be selected? If the Program Area operations are to be managed by an "operating committee", what mechanism will be used to make operational decisions?

(b) If one party is designated Program Operator, the Exploration Agreement should contain provisions concerning (i) the Program Operator's status as an independent contractor, (ii) the Program Operator's standard of conduct, (iii) the resignation and removal of the Program Operator and (iv) the selection of a successor Program Operator.

(c) Will the Program Operator be entitled to receive advance payment of all Program Area Costs, including the cost of conducting the Geophysical Survey (the "Geophysical Costs")? If so, will the Program Operator be required to maintain all such advance payments in a segregated account? The term "Geophysical Costs" should be defined to include all costs associated with seismic permitting, surface damages, data acquisition, initial processing and reproduction, but should specifically exclude interpretation costs. The term "initial processing" usually includes such processing as is required to deliver the final stack and migrated processed sections to the parties.

(d) What type of "spending controls" will be imposed on the Program Operator? Will the parties establish an "exploration budget" and require the Program Operator to stay within the budget? Will Program Area Costs be handled in the same manner as expenditures under the Operating Agreement, with the Program Operator submitting AFE's to the parties?

(e) What are the consequences of a party's failure to fund its share of the Geophysical Costs? Will such party be required to pay interest on the unpaid balance? Will the other parties have the right to withhold the Program Data from the defaulting party? Will the defaulting party be deemed to have gone nonconsent on all proposed operations until the unpaid amounts are paid in full? Will the defaulting party be required to forfeit its interest in the Program Area?

(f) If there is a bona fide dispute concerning the payment of Program Area Costs, how should such disputes be handled?

5. Program Area Operations.

(a) To prevent competition among the parties, the Exploration Agreement/Participation Agreement should contain an area of mutual interest ("AMI") provision that requires each party to offer the other parties the right to acquire their proportionate share of any oil and gas interest that is acquired within the AMI (the "Acquired Interest")? To avoid any claims that the AMI provision violates the Rule Against Perpetuities, it should have a fixed term.

(b) Under an Exploration Agreement, the lands that comprise the AMI are often the same as the lands that comprise the Program Area. Under a Participation Agreement, the AMI lands are usually larger than the Project Acreage. In either event, the description of the AMI will need to satisfy the requirements of the Statute of Frauds.

(c) What is included within the definition of "Acquired Interest"? In addition to Leases and options to acquire Leases ("Lease Options"), does Acquired Interest include seismic permits, royalty interests, mineral interests, farmouts and other oil and gas interests? What about interests in producing wells, disposal wells, gathering systems, production processing facilities, easements and surface use agreements? If an acquisition includes lands both inside and outside the AMI, will the acquiring party be required to offer both the "inside acreage" and the "outside acreage"? If only the inside acreage is required to be offered, how are the acquisition costs to be allocated between the inside acreage and the outside acreage? How will any "non-cash consideration" (*e.g.* drilling obligations, etc.) be shared?

(d) If a party does not participate in an Acquired Interest, how will the interest of the non-acquiring party be handled? What effect will the failure to participate in an Acquired Interest have on the non-acquiring party?

(e) To the extent any of the lands included within the Program Area are or may be covered by Lease Options, there should be a procedure in place to allow each party to elect whether or not it wants to participate in the exercise of such Lease Options. These procedures can be substantially the same as those set out for the Acquired Interests, with the Program Operator making the "exercise recommendations" to the other parties. If a Lease Option allows for the exercise of less than all of the acreage covered thereby, each party should have the right to participate in the exercise of such Lease Option for more or less acreage than is proposed by the Program Operator.

(f) Until such time as the Program Area Leases are included within a designated Prospect Area (and thereby covered by a separate Operating Agreement), the Program Operator is often responsible for coordinating delay rental payments by submitting rental payment recommendations to the other parties. As with the exercise of Lease Options, the parties should be given the right to participate or not participate in the recommended delay rental payments. Each party should also be given the right to make an "alternative" recommendation if the Program Operator proposes to make less than all of the required delay rental payments.

6. Designation of Prospect Areas. Once the Program Data is acquired, processed and distributed to the parties for interpretation, the process of identifying and designating Prospect Areas begins. The following are some of the issues to be considered when drafting this portion of the Exploration Agreement.

(a) How is "Prospect Area" to be defined? Is it a geological or geographical concept? If it is to be defined by subsurface structures or the estimated productive limits of the target formation, will the size of the prospect be limited to a certain number of contiguous surface acres? Will the Prospect Area be limited to the base of the deepest objective formation or will it include all depths? Can the originally designated Prospect Area be expanded or contracted after additional information is obtained from drilling operations?

(b) Who will be responsible for identifying prospects, designating Prospect Areas and proposing the initial wells that will test each prospect (the "Test Wells")? Will the Program Operator identify and propose prospects on behalf of all the parties or will each party have the right to identify and propose prospects? If all parties have the right to propose prospects and Test Wells, how will these "proposal activities" be coordinated? Will the parties meet periodically to discuss their prospect ideas? If so, how often?

(c) What information must be included in the proposal to form a Prospect Area and drill a Test Well (a "Well Proposal")?

7. Participation in Test Wells/Prospect Areas.

(a) Once a Well Proposal has been submitted, what election options are available to the non-proposing parties? The non-proposing parties are usually provided at least three (3) options: (i) to participate in the Well Proposal; (ii) to propose an alternative Well Proposal (either within the originally proposed Prospect Area or within a different Prospect Area; and (iii) to not participate in the Well Proposal. In some cases, a fourth option (to participate in the Well Proposal down to a specified depth) is added so as to allow a party to preserve its rights in the shallow formations when it does want to participate in a deep test.

(b) How long do the non-proposing parties have to respond to a Well Proposal? If a party responds to a Well Proposal by submitting an alternative Well Proposal, how will the competing Well Proposals be resolved? Will the party that made the unsuccessful Well Proposal be given a second opportunity to participate in the successful Well Proposal? If so, how much time will such party be given to make its election?

(c) A party's election to not participate in a Well Proposal usually results in such party relinquishing and assigning all of its rights in the Prospect Area to the participating parties. If the Test Well is not actually drilled to its deepest objective formation, will the nonparticipating party retain its rights in the Prospect Area? What if the Test Well is completed in a shallower formation?

(d) A party's election to participate in a Well Proposal down to a specified depth (the "Depth Limit") usually results in such party (the "Shallow Participant") relinquishing and assigning all of its rights in the Prospect Area below the Depth Limit. In the event of such an election, will the shallow formations and deep formations be governed by a single Operating Agreement? How will Lease acquisition costs, Lease Option exercise costs, delay rental payments and other lease maintenance payments be allocated between the owners of the shallow rights and the owners of the deep rights? How will the use of and/or access to Program Data and other Prospect Area information be impacted by the horizontal severance?

(e) In order to preserve its rights in the shallow formations, the Shallow Participant is usually required to pay its proportionate share of the cost of drilling the Test Well to the Depth Limit (the "Shallow Formation Costs"). How are the Shallow Formation Costs to be calculated? If a shallow completion is warranted, but is precluded by a completion in the deeper formations, will the Shallow Participant be entitled to a refund of its share of the Shallow Formation Costs until the deep formations cease producing in commercial quantities? After the Test Well is drilled, how will the parties handle subsequent well proposals to an objective formation located above the Depth Limit?

(f) If the Test Well is not drilled within a certain period of time (*e.g.* 90 or 180 days), what happens to the Well Proposal? Does the Prospect Area designation expire and become part of the Program Area again?

(g) Are there any limitations on the number of Test Wells that can be proposed or that can be drilled at any one time? If so, are there exceptions to these limitations if a well must be drilled to comply with the terms of a Farmout Agreement or to keep a Lease from expiring?

8. Prospect Area Operations. Once a Well Proposal is approved by the requisite ownership percentage of the parties entitled to participate therein, all operations thereafter conducted on the Prospect Area are governed by the Operating Agreement, with the Prospect Area being the "Contract Area" and the Test Well being the "Initial Well" thereunder. The following issues should be addressed when considering Prospect Area operations.

(a) How is the operator of each Prospect Area (the "Prospect Area Operator") to be selected? Should it be the Program Operator? Should it be the party with the largest interest in the Prospect Area? Should it be the party with the most "expertise" in the area?

(b) Once the parties designate Prospect Areas under the Exploration Agreement, each Prospect Area should have its own AMI, as set forth in the Operating

Agreement covering such Prospect Area. The Exploration Agreement will need a mechanism for removing the Prospect Area AMI's from the coverage of the Program Area AMI.

(c) If a party elects not to participate in one or more Prospect Areas, such nonparticipating party should agree not to acquire, or attempt to acquire, any oil and gas interest within such Prospect Area(s).

(d) The exercise of Lease Options and the acquisition and maintenance of Leases within the Prospect Area are usually managed by the Prospect Area Operator. What are the consequences of a party's failure to participate in the exercise of a Lease Option or in the acquisition of a Lease? What are the consequences of a party's failure to participate in a delay rental payment or other lease maintenance payment? Should the answer be different if the election is made <u>before</u> the Test Well reaches the objective depth? If the nonparticipating party is required to relinquish its interest in the Prospect Area, will such nonparticipating party be entitled to any compensation for its relinquished interest? On what basis will the participating parties share the nonparticipating party's relinquished interest?

9. <u>Audits and Dispute Resolution</u>.

(a) Each party should have reasonable access to those records pertaining to (i) operations conducted on the Program Area and (ii) operations conducted on any Prospect Area in which such party participated. How long will the Program Operator/Prospect Area Operator be required to maintain such records? What federal or state laws, rules or regulations should be considered before determining the record retention period? How are audit discrepancies to be handled? Are the procedures set forth in the COPAS Accounting Procedure adequate?

(b) How are disputes under the Exploration Agreement/Participation Agreement to be handled? Should the parties be required to submit all disputes to non-binding mediation before resorting to litigation? What about arbitration? If the parties agree to submit disputes to arbitration, how is the arbitrator to be selected? Is one arbitrator sufficient? How can the parties ensure that the arbitrator is qualified to hear the dispute? Should the parties agree to certain "expedited" arbitration procedures to reduce costs? How will the costs of mediation/arbitration be shared?

10. <u>Miscellaneous</u>.

(a) How long should the Exploration Agreement/Participation Agreement remain in full force and effect? How long will it take to conduct the contemplated exploration activities, identify prospects, designate the Prospect Areas and drill the Test Wells? Are there any provisions that should survive termination? Should the Exploration Agreement/Participation Agreement automatically terminate if certain events occur or certain milestones are not achieved?

(b) Should the Exploration Agreement contain a preferential right to purchase or a right of first offer with respect to each party's interest in the Program Area? What about a restriction on the assignability of a party's interest in the Program Area? If any such provisions are contained in the Exploration Agreement, should they apply only to those lands that are not included within a designated Prospect Area?

(c) What insurance will be maintained by the Program Operator/Prospect Area Operator? Will each party be required to provide its own insurance? What about indemnities? Does the jurisdiction in which the Program Area is situated have an anti-indemnity statute? Considerable attention should be given to coordinating the insurance and indemnity provisions of the Exploration Agreement/Participation Agreement with the indemnity provisions of the various contracts that are utilized in conducting operations on the Program Area/Project Acreage.

(d) What type of confidentiality and non-compete obligations are to be imposed on the parties? How long will such obligations last? What exceptions (if any) will there be to these obligations?

B. Farmout Agreements.

1. Description of Lands Covered. As described in Article IV.B. above, the Farmout Agreement must contain a valid legal description of the lands covered thereby. The most common way to do this is to include an Exhibit that describes all of the oil and gas leases that are covered by the Farmout Agreement (the "Farmout Acreage"). Of course, this Exhibit must include either (i) a legal description of the lands covered by each of the leases or (ii) the recording information for each of the leases. If there is to be an area of mutual interest ("AMI") and the AMI covers an area larger than the Farmout Acreage, a legal description of the AMI must also be provided. If Federal lands are to be included in the AMI, one will need to consider what acreage chargeability problems (if any) may be created.

2. Description of Formations Covered.

(a) Are all formations to be covered by the Farmout Agreement? If specific formations are to be excluded, determine the name of each formation, the depth to the top of each formation and the depth to the base of each formation so that they are easily identifiable. If deep formations are to be excluded, establish and define the maximum depth to which the farmee can earn. If shallow formations are to be excluded, establish and define the maximum depth for the formations to be retained by the farmor.

(b) If deeper formations are to be retained, but the depth which the farmee may earn is open, a method for establishing the greatest depth that may be earned must be agreed upon (*i.e.* 100 feet below the deepest depth drilled; 100 feet below the deepest depth drilled in any well that establishes production; to the base of the deepest producing formation, etc.).

(c) The use of "stratigraphic equivalent" to describe the "earned depth" should provide an adequate description as long as the formation to which the earned depth is equivalent can be identified on the log of a well in the vicinity of the Farmout Acreage. If an additional depth of 100 feet below the "stratigraphic equivalent" is to be earned (for operational purposes only), reference should be made to "100 feet below the stratigraphic equivalent of ___________", not "the stratigraphic equivalent of 100 feet below ___________".

(d) If there is a reasonable possibility that severe folding or thrusting of the formations may be encountered, the following type of language might be utilized to describe the "earned depth":

> **"all of Farmor's right, title and interest in and to those oil, gas and mineral leases described on Exhibit A attached hereto (the "Subject Leases") INSOFAR AND ONLY INSOFAR as the Subject Leases cover (i) all depths from the surface of the earth to 100 feet below the stratigraphic equivalent of the base of the ________________ Formation (the "Subject Interval") and (ii) all formations that are identified on the Dual Induction-SFL Log for the "Reference Well" (hereinafter defined) as being present within the Subject Interval, but that are located below the Subject Interval as a result of folding, faulting, thrusting or other movement of the earth's strata. For purposes of this Agreement, (i) the term "Reference Well" shall mean the Wildcat #1 Well, situated 400 feet from the north line and 2,000 feet from the west line of Section 2, Township 5 North, Range 26 West, _______ County, Arkansas and (ii) the base of the ____________ Formation is defined as the correlative stratigraphic equivalent to that point found at the depth of ____ feet measured depth on the Dual Induction-SFL Log for the Reference Well."**

3. Existing Contracts and Co-Owner Issues.

(a) Are the lands subject to existing Exploration Agreements, Participation Agreements, Operating Agreements or other agreements with co-owners or other third parties that must consent to the farmout?

(b) Did mineral owners retain rights to take in kind, consent to assign, etc., that must be considered?

(c) Do co-owners have preferential purchase rights to be considered before the company can enter into a Farmout Agreement with others?

4. Overriding Royalty.

(a) What overriding royalty, if any, is to be reserved by the farmor (the "Retained Override")? It should be made clear that any Retained Override is in addition to existing overrides, production payments or other encumbrances and it should be stated in gross (*i.e.* a percentage of 8/8ths) so that the "proportionate reduction" clause will apply. In this regard, it is important that the proportionate reduction clause relate both to the lessor's interest in the minerals as well as the farmor's interest in the leases. If the Retained Override is to attach to any extension or renewal of the leases, language should be added to express such intent.

(b) If the Retained Override is reserved in the assignment to the farmee, for tax purposes, the assignment is deemed to be a sublease. The consequence of this characterization is that any basis that the farmor has in the Farmout Acreage "attaches" to the Retained Override and is not deducted from any cash payment the farmor may receive (if any) for purposes of determining the taxable value of such cash payment.

(c) If the farmee is assuming all existing overrides and/or other burdens, such burdens should be specifically identified and the farmee's net revenue interest in the Farmout Acreage should be clearly set out in the Farmout Agreement.

5. Well Takeover.

(a) Will the farmor reserve the right to require the farmee to tender any drilling well back to the farmor prior to abandonment? This is sometimes of interest where the farmor is reserving the deep rights. If the farmor reserves this right, the Farmout Agreement should specify (i) the time limit within which the farmor must accept the well, (ii) who pays for rig stand-by time, etc., (iii) the size of the well bore and the casing program employed by the farmee and (iv) whether the farmor is required to reimburse the farmee for the net salvage value of the well.

(b) If the Farmout Agreement is a "multiple well trade", the parties will need to agree upon the amount of acreage that will be withdrawn from the Farmout Acreage if the farmor takes over the farmee's well and establishes production.

6. Lease Maintenance Payments. Consideration must be given to how to treat the various types of "lease maintenance payments". Often times the leases subject to the Farmout Agreement are held by production when the deal is made and are later renewed and require rentals in order for them to be perpetuated.

(a) *Delay Rentals.*

(1) Who will be responsible for paying delay rentals? How will delay rentals be borne? In those Farmout Agreements where the farmor retains a working interest in any formation, the farmor often pays the delay rentals and bills the farmee/assignee on a surface acre (prorated) basis for reimbursement.

(2) After an earning well is drilled and an assignment of all of the farmor's working interest in all depths is delivered to the farmee, the burden of paying delay rentals should shift to the farmee as to the portion of the lease(s)

assigned, provided the lease terms allow for the division of the delay rental obligation.

(b) *Shut-In Payments.* Shut-in payments, unlike delay rentals, are normally paid by the farmee/assignee. In many instances, such payments must be made prior to or within a specified period of time after the farmee's well is shut-in and are generally payable to royalty owners, which many times are different than the delay rental recipients. Therefore, the title examination work and the job of setting up the payment decks for making such payments should be handled by the party drilling the well.

(c) *Minimum Royalty Payments.* For those leases that provide for minimum royalty payments, the following issues should be considered:

(1) Who will be responsible for administering the payments and accounting to the royalty owners?

(2) Will any minimum royalty "shortfall payment" be borne pro rata by all working interest owners or will it be borne by those owners whose royalty payments were not sufficient to meet the minimum royalty requirements?

(3) If the lease is severed horizontally and production is from only one owner's portion, do all owners share in any minimum royalty shortfall payments that may be required? If all of the owners share in such payments, on what basis do they share?

(4) The farmee/assignee should be required to timely advise (with written documentation) the amount of royalty the farmee/assignee has paid for its interest, regardless of whether or not the farmee/assignee will be required to share in any minimum royalty shortfall payments.

7. Loss/Failure of Title.

(a) Is failure of title a joint or individual loss? If the loss is because of nonpayment or an erroneous payment of rental or royalty, who will be responsible for renewing the affected lease(s)? How are the renewal costs to be borne? Are all parties entitled to participate in renewals after loss or failure of title? For how long? One year, six months?

(b) Will any Retained Override attach to a lease that is renewed as a result of a title failure?

8. Well Obligations.

(a) The Farmout Agreement should specifically address whether or not a dry hole will earn any rights.

(b) Is the drilling obligation "firm" or an option? The farmor will want the drilling requirement to be a firm obligation, especially when a loss of one or more leases or loss of a business opportunity is likely to occur if the well is not drilled by the farmee.

(c) What type of commencement is required to comply with the Farmout Agreement, operations or actual drilling? Compliance is much easier to verify if actual drilling is required.

(d) Is there a requirement to either commence or complete the well by a specified date? If so, is such requirement subject to force majeure?

(e) Is the objective depth firm?

(f) If the obligation is firm, and the farmee does not perform, what is the proper measure of damages? Since it may be very difficult to prove the actual amount of damages that are incurred by the farmor, the parties should agree to a liquidated damage amount.

(g) If drilling the "earning well" is intended to be an option, the Farmout Agreement shoulo expressly state such intent and provide that the penalty for the farmee's failure to perform shall be limited to the loss of the right to earn assignments under the Farmout Agreement.

9. Location and Depth of Initial Well.

(a) The location of the initial test well should be specifically identified. The parties should verify that the proposed location is a "legal location" under applicable field rules.

(b) The formation(s) to be tested or penetrated should also be specifically identified. If the formation is identified by reference to an interval in a nearby well, the Farmout Agreement should include the complete name and location of the reference well, and identify the interval by depth on a log of the reference well.

(c) If the Farmout Agreement requires only that the formation be penetrated, the Farmout Agreement should specify the amount of penetration required (*i.e.* 50 feet - 100 feet, etc.).

(d) To avoid any costly "geological surprises", the farmee will prefer that the objective depth be defined as the lesser of (i) the stratigraphic equivalent of the target formation or (ii) a stated total depth.

10. Earning Requirements.

(a) Will the establishment of production before the objective depth is reached earn for the farmee/assignee or must it continue drilling the well (or an alternate well) to the objective depth to earn?

(b) When will the farmee receive an assignment under the Farmout Agreement? Is the Farmout Agreement to be structured as an "agreement to transfer" or an "upfront conditional assignment"?

(c) If the farmee's drilling obligation is intended to be a condition and not a covenant, such intent should be expressly stated in the Farmout Agreement. The failure to clearly state that an obligation is a condition, and not a covenant, can result in the non-breaching party being relegated to an action for damages if the obligation is not performed.

(d) If the farmor retains a carried working interest, is the farmee required to carry the farmor to "casing point" or through completion of the well? If the farmor is to be carried through completion of the well, what does "completion" mean? Does it include all costs of completing and equipping the well "through the tanks" (including the cost of all flow lines up to and including the wellhead check meter)?

11. Continuous Development Provisions.

(a) If the trade calls for continuous drilling of wells until or after production is established, the Farmout Agreement should specifically state how long the farmee has between wells and the type of action that is required to be commenced for each well, either operations or actual drilling.

(b) Is the objective depth for each of the successive wells the same as for the initial well or will production at any depth earn rights under the Farmout Agreement after the initial well has reached the objective depth?

(c) Can time between wells be accumulated (*i.e.* "banked") in the event the farmee commences operations/drilling on the next required well prior to the required commencement date?

12. Large Acreage Blocks.

(a) If the Farmout Agreement covers a single large block of acreage or several separate blocks in a trend, consideration should be given to requiring multiple "initial" or "earning" wells. If several "initial wells" are required to be drilled, is it clear when each initial well must be commenced on each area? Is there an order of preference for drilling the separate areas? Will the same depth requirement be applicable to each separate area?

(b) If production must be established to earn rights under the Farmout Agreement, will the farmee have an option to drill successive wells on each separate area until production is established? Does this option apply as to each area separately (which might require the farmee to have several rigs running at the same time) or may the farmee hold all unearned areas by continuously drilling on a single area?

(c) If the farmor is retaining deep rights, how will the "earned depth" be determined under each separate area?

(d) If the farmee is required to establish production to earn rights under the Farmout Agreement and the farmee's first well is a deep dry hole, but production is established in a subsequent shallower well, does the farmee earn rights as to all depths explored by the deep dry hole or only those depths explored by the shallower producing well?

13. Substitute Wells. Most farmout trades include a "substitute well provision" that will permit the farmee to drill a new well if the initial well is lost because of impenetrable conditions, heaving shale, excessive saltwater flows, etc. The Farmout Agreement should specify how much time may elapse between abandonment of the lost well and commencement of the substitute well. The Farmout Agreement should also specify how the location of the substitute well is to be selected.

14. Alternate Wells. If the farmee discovers hydrocarbons in a shallow formation, the farmee may want to attempt a completion in such shallow formation before drilling on to the objective depth so as not to jeopardize the chances of completing in the shallower zone. Since the well is still in good condition, the substitute well clause (described above) will not apply. To cover such situations, an alternate well provision must be included.

15. Payout Provisions. Many Farmout Agreements provide that once the farmee has recouped the cost of drilling the well from the well's production (*i.e.* payout), the farmor is entitled to "back in" for a percentage of the working interest, whereupon the well becomes a "joint account" well under the attached Operating Agreement. To avoid disagreements about when "payout" occurs, it is important that the Farmout Agreement specifically provide how "payout" is to be calculated and require the farmee to account to the farmor on a monthly basis with a payout statement. The payout statement should be in sufficient detail to reflect (i) the total drilling costs to be recouped by the farmee, (ii) the items that make up such total amount (tangibles and intangibles), (iii) the total cumulative amount of production from the well during the payout period, (iv) the amount and value of production from the well since the previous statement and (v) the balance of the payout amount yet to be recouped.

APPENDIX A

1982 AAPL FORM – ARTICLE XV
OTHER PROVISIONS

The provisions of this Article XV shall take precedence over any provisions of the printed portion of this agreement which may be in conflict herewith.

A. Definitions.

As used in this agreement, the following terms shall have the meanings set forth below:

1. The term "Aggregate Recoupment Amount" shall mean, with respect to a particular party hereunder, the sum of the outstanding Recoupment Amounts for all non-consent wells in which such party has elected, or has been deemed to have elected, to be a Non-Consenting Party hereunder.

2. The term "Commission" shall mean the Arkansas Oil & Gas Commission or any successor regulatory body having jurisdiction.

3. The term "drilling unit" shall mean the governmental section (or the equivalent thereof) covered by this agreement. For purposes of this agreement, the term "drilling unit" and "Contract Area" shall refer to the same lands.

4. The term "completion" or "complete" shall mean a single operation intended to complete a well as a producer of oil and gas in one or more zones, including, but not limited to, the setting of production casing, perforating, well stimulation and production testing conducted in such operation.

5. The term "deepen" or "deepening" shall mean a single operation whereby a well is drilled to an objective zone below the deepest zone in which the well was previously drilled, or below the deepest zone proposed in the associated AFE, whichever is the lesser. The term "deepen" or "deepening" shall not be interpreted to mean further extension of a horizontal drainhole nor shall it be interpreted to pertain to any vertical stratigraphic variations within any particular formation as might be encountered while "steering" during horizontal or directional drilling operations.

6. The term "integration order" shall mean any order by the Commission requiring the integration of any and all leasehold interests, oil and gas interests and other applicable interests within the Contract Area for purposes of operating the Contract Area as one integrated unit pursuant to the terms of this agreement.

7. The term "non-consent well" shall mean any well in which less than all parties have conducted an operation as provided in Article VI.B.2.

8. The term "plug back" or "plugging back" shall mean a single operation whereby a deeper zone is abandoned in order to attempt a completion in a shallower zone.

9. The term "production infrastructure" shall mean all facilities that are necessary to produce, treat, gather, compress and market oil and gas, and to dispose of any produced waters, from the wells drilled under this agreement.

10. The term "recompletion" or "recomplete" shall mean an operation whereby a completion in one zone is abandoned in order to attempt a completion in a different zone within the existing wellbore.

11. The term "Recoupment Amount" shall mean, with respect to each non-consent well drilled hereunder, the sum of the amounts described in subparagraphs (a) and (b) of Article VI.B.2. for each such non-consent well.

12. The term "rework" or "reworking" shall mean an operation conducted in the wellbore of a well after it is completed to secure, restore, or improve production in a zone which is currently open to production in the wellbore. Such operations include, but are not limited to, well stimulation operations, but exclude any routine repair or maintenance work or drilling, sidetracking, deepening, completing, recompleting or plugging back of a well.

13. The term "sidetrack" or "sidetracking" shall have the meaning given to such term in Article VI.B.4. hereof.

B. Well Proposals.

Notwithstanding anything contained herein to the contrary, to be effective, any proposal to conduct an operation under Article VI.B. hereof must be approved by a majority in interest of the parties entitled to participate in such operation.

C. Parties to Operations.

1. Except as otherwise provided in Article XV.C.5. below, with respect to any non-consent well drilled or deepened pursuant to Article VI.B.2. for which the Consenting Parties have not been fully reimbursed for the amounts provided in Article VI.B. (as modified by Article XV.F.), the right to propose and to participate in further operations under Article VI.B. for such non-consent well shall be limited as follows:

   a. Only a Consenting Party in the non-consent well shall have the right to propose a reworking, plugging back, completion or recompletion operation for such non-consent well, provided that (i) all parties (including Non-Consenting Parties in such non-consent well) shall be entitled to receive notice of any such proposed operation (a "Proposal Notice") and (ii) all Consenting Parties in such non-consent well and any Non-Consenting Party in such non-consent well that has prepaid its Aggregate Recoupment Amount shall have the right to participate in such operation pursuant to Article VI.B. In order for a Non-Consenting Party to be entitled to participate in the operation described in a Proposal Notice, such Non-Consenting Party must (i) provide all parties with written notice that such Non-Consenting Party intends to make a cash prepayment of the Aggregate Recoupment Amount, which prepayment notice must be delivered to all such parties no later than five (5) days (or forty-eight (48) hours if a drilling rig is on location) following such Non-Consenting Party's receipt of the Proposal Notice and (ii) deliver the prepaid Aggregate Recoupment Amount to Operator (for the account of all Consenting Parties) no later than ten (10) days following such Non-Consenting Party's receipt of such Proposal Notice.

b. Only a Consenting Party in the non-consent well shall have the right to propose a deepening or sidetracking operation for such non-consent well, but all parties (including Non-Consenting Parties in such non-consent well) shall be entitled to receive the Proposal Notice for, and shall have the right to participate in, such sidetracking or deepening operation pursuant to the terms of Article VI.B. However, those Non-Consenting Parties that elect to participate in such deepening or sidetracking operation shall reimburse the Consenting Parties in accordance with Article VI.B.4. in the event of a sidetracking operation and in accordance with Article XV.C.(3) below in the event of a deepening operation.

2. If less than all the parties elect to participate in a drilling or deepening operation proposed pursuant to Article VI.B., the interest relinquished by the Non-Consenting Parties to the Consenting Parties under Article VI.B.2. or Article XV.D., as appropriate, shall relate only and be limited to the lesser of (i) the total depth actually drilled or (ii) the objective depth or formation of which the parties were given notice under Article VI.B.1. (the "Initial Proposed Objective"). Such well shall not be drilled to a depth deeper than the Initial Proposed Objective without first complying with Article XV.C.(3) to afford the Non-Consenting Parties the opportunity to participate in such deeper drilling operation.

3. In the event any Consenting Party desires to drill or deepen a non-consent well to a depth below the Initial Proposed Objective, such Consenting Party shall give notice thereof, complying with the requirements of Article VI.B.1., to all parties (including Non-Consenting Parties in such non-consent well). Thereupon, Article VI.B. or Article XV.D., as appropriate, shall apply and all parties receiving such notice shall have the right to participate or not participate in the drilling of such well pursuant to said Article VI.B. or Article XV.D. In the event, however, any Non-Consenting Party elects to participate in the deeper drilling operation, such Non-Consenting Party shall pay or make reimbursement (as the case may be) of the following costs and expenses:

a. If the proposal to drill deeper is made prior to the abandonment or proposed abandonment of such non-consent well as a dry hole or prior to completion of such non-consent well as a commercial well, such Non-Consenting Party shall pay (or reimburse Consenting Parties for, as the case may be) that share of all costs and expenses incurred in drilling such non-consent well from the surface to total depth, as deepened or proposed to be deepened, which such Non-Consenting Party would have paid if such non-consent well had initially been proposed to be drilled to such depth and such Non-Consenting Party had agreed to participate therein; provided, however, all costs for testing and completion or attempted completion of such non-consent well that were incurred by the Consenting Parties prior to the point of actual operations to drill deeper than the Initial Proposed Objective shall be for the sole account of the Consenting Parties.

b. If the proposal to drill deeper is made for a non-consent well that has been previously completed as a commercial well but is no longer producing in paying quantities, such Non-Consenting Party shall, in addition to paying all costs of re-entering such non-consent well and deepening the same below its total depth, also reimburse Consenting Parties for the lesser of (i) such Non-Consenting Party's proportionate part (based on the percentage of such non-consent well the Non-Consenting Party would have owned had it previously participated in such non-consent well) of the salvable materials and equipment remaining in the hole and salvable surface equipment used in connection with such deeper drilled well or (ii) the amounts yet unrecovered under Article VI.B. (as modified by Article XV.F.) that the Consenting Parties are entitled to recover from such Non-Consenting Party's relinquished interest in such non-consent well.

The foregoing shall not imply a right of any Consenting Party to propose any deeper drilling operation for a non-consent well prior to completion of the drilling of such non-consent well to casing point for its Initial Proposed Objective without the consent of all other Consenting Parties.

The provisions of this Article XV.C. shall not apply to the takeover of a well by the Non-Consenting Parties in the event all Consenting Parties elect to permanently plug and abandon the same, but such right of the Non-Consenting Parties shall be governed by Article VI.E.3.

4. It is agreed that no reworking, deepening, plugging back, completion, recompletion or sidetracking operation shall be conducted on any well then capable of producing in paying quantities except with the consent of all parties that have not relinquished interests in the well at the time of such operation.

5. If one or more, but less than all, parties elect to participate in a completion or recompletion attempt on a vertical or directional vertical well (collectively, a "vertical well") pursuant to Article VII.D.1. (Option No. 2), the provisions of Article VI.B.2. shall apply to the operations thereafter conducted by less than all parties; provided, however, that Article VI.B.2. shall apply separately to each such completion or recompletion attempt undertaken thereunder, and an election to become a Non-Consenting Party as to one completion or recompletion attempt shall not prevent a party from becoming a Consenting Party in subsequent completion or recompletion attempts on such vertical well, regardless whether the Consenting Parties as to earlier completions or recompletions have recouped their costs pursuant to Article VI.B.2. In this regard, the parties agree that any recoupment of costs by a Consenting Party in a particular completion or recompletion attempt shall be made solely from the production attributable to the zone in which the completion or recompletion attempt is made. An election by a previous Non-Consenting Party to participate in a subsequent completion or recompletion attempt shall require such party to pay its proportionate share of the cost of salvable materials and equipment installed in the well pursuant to the previous completion or recompletion attempt, insofar and only insofar as such materials and equipment benefit the zone in which such party has elected to participate in such completion or recompletion attempt. For the purpose of the preceding sentence, the term "zone" shall be limited to the interval in the wellbore that is to be perforated.

D. Required Operations.

It is understood and agreed that the non-consent provisions of Article VI.B.2. shall not be applicable to the drilling of any well or operation which will serve to perpetuate any lease(s), or part thereof, or interest within the Contract Area which is expiring within six months after the date such well or operation is proposed and/or to earn or preserve the right to earn leasehold interests owned by a third party pursuant to a written agreement therewith which would otherwise expire in the absence of operations. Any such well or operation is hereinafter called a "Required Operation". As to any Required Operation proposed by any party hereto in which any other party hereto elects not to participate, the Non-Participating Party shall release and relinquish forever to the Participating Parties, proportionately, all of such Non-Participating Party's interest in and to any well, agreements, and leases, or portions thereof, or interest within the Contract Area which will be perpetuated or earned by such Required Operation, together with any leases or interest pooled therewith to form a drilling unit under the Commission's regulations. Any interest surrendered shall be assigned by the Non-Participating Party to the Participating Parties on a prorata basis, without warranty of title except as to claims by, through or under such Non-Participating Party, and same shall be free and clear of any additional burdens and shall remain subject hereto. Nothing contained herein shall be construed as requiring a relinquishment of such Non-Participating Party's interest in any producing wells or units.

E. Horizontal Wells.

1. Notwithstanding anything contained herein to the contrary, (i) the provisions of Article VII.D.1 Option No. 1 shall apply to any "horizontal well" (hereinafter defined) proposed hereunder and (ii) the provisions of Article VII.D.1. Option No. 2 shall apply to all other wells proposed hereunder that are not expressly proposed as "horizontal wells". To be effective as a "horizontal well proposal", such proposal must include an AFE and other accompanying documents that clearly stipulate that the well being proposed is a horizontal well. For purposes of this agreement, a "horizontal well" is defined as a well drilled, completed or recompleted in a manner in which the horizontal component of the completion interval in the objective formation(s) exceeds the vertical component thereof and which horizontal component exceeds a minimum of one hundred feet (100') in the objective formation(s). As to any possible conflicts that may arise during the completion phase of a horizontal well, priority shall be given first to a lateral drain hole of the authorized depth, and then to objective formations in ascending order above the authorized depth, and then to objective formations in descending order below the authorized depth.

2. Operator shall have the right to cease drilling a horizontal well at any time, for any reason, and such horizontal well shall be deemed to have reached its objective depth so long as Operator has drilled such horizontal well to the objective formation and has drilled laterally in the objective formation for a distance which is at least equal to fifty percent (50%) of the length of the total horizontal drainhole displacement (displacement from true vertical) proposed for the operation.

F. Non-Consent Wells.

Notwithstanding anything contained in this agreement to the contrary, the nonconsent provisions contained in Article VI.B.2. hereof shall be amended as follows:

1. The provisions of Article VI.B.2. shall apply to both the initial well drilled on the Contract Area pursuant to Article VI.A. and all subsequent wells drilled on the Contract Area under Article VI.B.

2. If a party elects not to participate, or is deemed to have elected not to participate, in a well drilled on the Contract Area, such Non-Consenting Party shall also relinquish its right to propose and to participate in any and all subsequent wells drilled on the Contract Area, and such party shall be deemed to be a Non-Consenting Party under Article VI.B.2. and this Article XV.F. with respect to all such subsequent wells. However, at such time as the Consenting Parties have received a Non-Consenting Party's Aggregate Recoupment Amount from (i) such Non-Consenting Party's relinquished interest in all non-consent wells drilled hereunder or (ii) such Non-Consenting Party's cash prepayment of the Aggregate Recoupment Amount, such Non-Consenting Party shall again be entitled to propose and to participate in any subsequent wells thereafter drilled on the Contract Area.

3. A Non-Consenting Party's relinquished interest in each non-consent well drilled hereunder shall not revert to such Non-Consenting Party until the Consenting Parties have received the Non-Consenting Party's Aggregate Recoupment Amount from (i) such Non-Consenting Party's relinquished interest in all non-consent wells drilled hereunder or (ii) such Non-Consenting Party's cash prepayment of the Aggregate Recoupment Amount.

G. <u>Integration Order</u>.

Operator and Non-Operators recognize that the drilling unit covered by this agreement is and/or may be subject to an integration order issued by the Commission under § 15-72-304 of the Arkansas Code. Pursuant to the terms of any such integration order, (i) all tracts and interests included within the drilling unit shall be integrated for the development or operation thereof for oil and gas, (ii) all operations to be conducted on the drilling unit shall be proposed and conducted in accordance with the terms of this agreement (whether or not the owners of the leasehold interests and oil and gas interests within the drilling unit actually execute this agreement) and (iii) the nonconsent provisions contained in Article VI.B.2. of this agreement (as amended by Article XV.F. above) shall apply to all "nonparticipating owners" (as such term is used in § 15-72-304) in the drilling unit.

H. <u>Production Infrastructure</u>.

Each party agrees to pay its proportionate share of all costs and expenses incurred in connection with the acquisition, construction, installation and operation of all production infrastructure associated with the wells in which such party elects to participate. For purposes of calculating the Recoupment Amount for each non-consent well drilled hereunder, the cost of acquiring, constructing and installing all production infrastructure associated with each such non-consent well shall be included within the costs described in subparagraph (a) of Article VI.B.2 hereof.