Mineral Exploration Funds

Harold S. Bloomenthal
Finding an appropriate vehicle to bring together those high-bracket taxpayers having risk capital to invest with mineral operators engaged in mineral development, and in need of such capital, gives rise to a rather perplexing combination of legal problems. Professor Bloomenthal suggests the mineral exploration fund as one such vehicle. The primary objective of the article which follows, says the author, is to provide a common understanding for counsel wherever located with respect to the mineral, tax, SEC, business association and other problems involved in the organization, financing and operation of such a fund.

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Independent mineral operators have decried for years the lack of available capital for mineral development. Yet those with capital to venture often have equal difficulty in finding responsible mineral operators. Since the available capital is very likely to be found in locales (generally the eastern United States) other than those (generally the western United States) in which mineral operations are being carried on, problems are presented in bringing together these two groups with complementary interests. The principal legal problems involved in this process are providing appropriate legal vehicles and mechanics through which the varying objectives of the parties can be best realized. One such vehicle is the exploration fund.

The exploration fund is a means of channeling risk capital furnished by high-bracket taxpayers into mineral exploration, particularly for oil and gas. Typically such funds are sponsored ("promoted") by knowledgeable mineral operators who utilize the peculiar tax advantages of mineral
operations to lure capital. For this reason, exploration funds are generally designed to permit the taxpayer-investor to write off a substantial portion of his "investment" as a deduction against current income. While many funds offer their securities publicly, undoubtedly there are a number of private placements of such securities. Although in the past exploration funds have been concerned primarily, if not exclusively, with oil and gas exploration and development, there are no inherent reasons why such funds could not be utilized as advantageously for other types of mineral exploration. The parties participating in an exploration fund are likely to be represented by counsel which are widely separated geographically and of widely diverse backgrounds and experiences. Eastern counsel, for example, is likely to be more familiar with the legal implications of financing and general taxation, whereas western counsel is likely to be more familiar with mineral law and mineral taxation. The primary objective of this article is to provide a common understanding for counsel wherever located with respect to the mineral, tax, SEC, business association, and other problems involved in the organization, financing, and operation of such funds.

A PRELIMINARY LOOK AT THE EXPLORATION FUND

The prospectuses filed with the Securities and Exchange Commission by seven exploration funds having 1967 programs have been examined in connection with the preparation of this article. The seven funds were chosen at random, but the sampling is not necessarily representative since there were at least twenty-three additional exploration funds which filed registration statements with the Commission pertaining to 1967 exploration programs. However, the funds examined do appear to cover a wide variety of arrangements and, while probably not exhausting the possibilities in this regard, appear to reflect the more likely alternatives. No examination has

1. Two of the exploration funds examined were under common control and offered similar programs except that one limited itself to the exploration of unproven ("wildcat") properties whereas the other acquired only proven and semi-proven properties.

2. See Securities Act Registration List, 1967 CCH FED. SEC. L. REP. p. 8011. Since at any one time this list shows only registration statements which were filed and are not yet effective or those which became effective within the last three months, the author's count is necessarily incomplete. Successive separate offerings of funds which are otherwise identical have been counted as a single fund.
been made of funds which have been financed in reliance on the exemption for non-public offerings.

While there may be significant variations in the arrangements chosen by a promoter, a sale of a security is generally contemplated by which the sponsor is to receive from investors monies or a commitment to make monies available for use in the acquisition and drilling of oil and gas properties. In return the sponsor makes available to the fund the necessary administrative experience and is responsible for the acquisition of the mineral properties, as well as their exploration, development, and operation. All of the funds examined were of the "blank check" type; i.e., none of them had specific properties in the fund or committed to the fund at the date of the prospectus. In most instances the investors had no control over the choice of properties acquired for the fund, although one plan did allow each investor the option of refusing to participate in specific acquisitions, and another fund granted such a choice to certain categories of participants. Five of the seven funds intended primarily, if not exclusively, to acquire unproven ("wildcat") oil and gas properties. One of the funds planned to acquire only proven and semi-proven interests, and the remaining fund intended to acquire primarily proven properties, although its ability to do so appears questionable. One of the "wildcat" funds also represented that it intended to secure properties amenable to a secondary recovery program. Five of the funds anticipated exploration exclusively within or off shore of the United States, with three of them hoping to concentrate their acquisitions primarily in the Texas and mid-continent areas. One plan foresaw only Canadian and off shore development; and another fund, while planning to acquire properties primarily in the United States, reserved the right to spend one-third of the proceeds on Turkish oil and gas interests.

Of the seven funds examined, five employed underwriters and paid underwriting commissions. The other two funds offered their securities directly through the employees of the

3. See text accompanying notes 153-60 infra.
4. Orthodox drilling and producing techniques never withdraw all of the oil in a reservoir because the natural pressure necessary to force up the oil is inevitably exhausted before the mineral source is exhausted. A secondary recovery program involves an attempt to secure further production by injecting water or gas into the reservoir at strategic points with the hope that part of the remaining oil will be driven toward existing wells.
sponsor, one paying commissions to such employees and the other placing one of its employees on a salary for supervising the offering.\footnote{5} The underwriting commissions paid varied from two to seven percent\footnote{6} and, in most cases, a substantial portion of the underwriting commissions was reallowable to participating dealers.\footnote{7} Two underwriting firms were apparently organized for the specific purpose of offering securities of the particular exploration fund from which the firm’s compensation was paid. In two other instances the underwriters were established securities firms which were either primarily responsible for or closely associated with the sponsor-

orship of the fund. In only one plan did the underwriter appear to have no affiliation with the sponsor or the fund. All the underwritings were on a best-efforts basis, and in all programs the expenses of the offering were to come out of the proceeds of the offering. Estimates of such expenses varied from $18,000 to $50,000.

Generally, the sponsor company, its officers, directors, or affiliates claimed prior experience with oil and gas exploration, although the extent of such experience varied considerably. Only one of the funds had an experienced staff which devoted all of its efforts to the management of exploration funds. The direction of the other six funds was a part-time endeavor for the particular staffs. However, several of the

\footnote{5} Some of the sponsors may arguably be “brokers” as that term is defined by § 3(a)(4) of the Securities Exchange Act, 15 U.S.C. § 78c(a)(4) (1964), or “broker-dealers” within the definition of § 401(c) of the Uniform Securities Act. A sponsor’s classification as a “broker” under § 3(a)(4) would depend upon his being “engaged in the business of effecting transactions in securities for the account of others...” 15 U.S.C. § 78c(a)(4) (1964) (emphasis added). It appears to be difficult to conclude that exploration fund sponsors could be so classified unless the fund is viewed as some type of “entity.” However, under the Uniform Securities Act broker-dealer classification would follow if the sponsor were found to be a non-issuer engaged in the business of effecting transactions in securities for its own account. The possible classification of the sponsor as an issuer is discussed in the text accompanying notes 161-68 infra. A few states require a form of broker-dealer registration for an “issue-dealer.” E.g., COLO. REV. STAT. ANN. §§ 125-1-2, -12 (1962). In any event, registration as an “agent” would be necessary under §§ 401(b) and 201(a) of the Uniform Securities Act for those active in the sale of fund interests. This registration may involve among other things furnishing an appropriate bond and passing a mandatory examination. Whether such persons would be “brokers” under the Exchange Act, and subject to registration thereunder, would depend upon whether their activities in selling such securities constituted a “business.” See generally H. BLOOMENTHAL, SECURITIES LAW 209-11 (1966).

\footnote{6} In two of the funds examined by the author the dealers’ commissions were paid by the sponsor and were not taken out of the participants’ investments.

\footnote{7} All of the funds, including those not employing an underwriter, invited participation by members of the National Association of Securities Dealers, with appropriate commissions payable to those securing purchasers.
In all seven funds the sponsor or management company was compensated primarily, though not always exclusively, by the grant of an interest in the properties to be acquired by the fund. Three sponsor companies acquired a so-called “carried-interest” which permitted the investors to receive the return of their investment before participation by the sponsor. The sponsor’s compensation in two funds under common control took the form of a net profit interest defined in a manner which granted the sponsor-manager immediate participation with general investors. Another fund’s manager-sponsor was allowed immediate participation during the payout period, which at the sponsor’s election could be converted into a net profit interest after payout to investors. The sponsor of the seventh fund did not receive an interest in the property on which exploratory wells were drilled, but was granted an undivided proprietary right in surrounding acreage. Thus, this latter sponsor would benefit from its promotion of the fund only if the contemplated exploration was successful. While successful development might appear requisite to the compensation of sponsors who received only a carried interest, since their participation is subordinate to that of the general investor, a few of these sponsors took compensation directly out of the offering proceeds and/or realized profits in the sale of properties to the fund. Yet, one is impressed with the fact that in general the manager-sponsors are utilizing these funds primarily as a means of obtaining mineral interests at no risks to themselves. In two of the funds examined a substantial portion of the sponsor-manager’s own monies would be invested, since these promoters were committed to contribute amounts to the fund on the same basis as the general public. One suspects that the reasonableness of the underwriting and management “fee” arrangements may have been “encouraged” by attitudes informally expressed by members of the SEC staff.

Of the five funds anticipating exploration of wildcat oil properties, four proposed that offering proceeds would be
used only in the drilling of exploratory wells and would not be used to complete wells or to drill additional development wells in the event oil should be discovered. The four plans contemplated either borrowing funds for these purposes, or “assessing” the participants for their proportionate share of completion or development costs. While in most cases the participants did not have to contribute to the cost of drilling development wells, the investor typically had a firm obligation to bear his proportionate share of the expense of completing a well that had yielded an oil producing sand. If a participant fails to meet his obligation, he is generally subject to a penalty in favor of the person making a contribution on his behalf. Under some arrangements he forfeits all of his interest in the acreage other than the unit on which the exploratory well has been drilled. Usually the person advancing the non-contributor’s share of such costs is entitled to recover three hundred percent of the amount advanced out of the defaulter’s share of production in the event the well should be successful.

The funds examined generally contemplated the immediate distribution to the investors of the proceeds from production. Nevertheless, two of the funds, both under affiliated sponsorship, required all amounts generated through production or otherwise to be reinvested for a period of ten years. The majority of the funds examined were established on an annual basis—monies were raised and expended during a given year and the participants’ obligations terminated after the initial commitment had been depleted. One of the funds, however, required annual commitments over an indefinite number of years. All the funds had minimum commitment requirements varying from $1,500 in one fund to $25,000 in another. Presumably, a large minimum commitment should be effective in screening out small investors.

THE ANALOGY TO MUTUAL FUNDS

The use of the term “fund” suggests that exploration funds have something in common with mutual funds and some of the plans examined were not beyond exploiting this

8. Prior to completion of a well, it is difficult to determine whether an apparent discovery will in fact produce oil in commercial quantities. Further, there is a very real possibility that mechanical difficulties will be encountered in completing and/or producing a well. In light of these two factors, borrowing production funds on the basis of an apparent discovery may prove to be
identification. Thus, three of the seven funds used the word "Fund" in their name and their prospectuses utilized words such as "Plan," "Participant," "Withdrawal Plan," "Custodian," and "Manager," all of which are familiar mutual fund terminology. Only two of the seven expressly stated that their operations were not investment companies.

In a general sense exploration and mutual funds do have some things in common. One of the principal similarities is that both have "managers" who provide the administration and professional services necessary to select and supervise the funds' investments—in one case the acquisition of mineral properties and in the other the selection of a portfolio of securities. Other similarities include the pooling of funds of many investors with the enhanced opportunity for diversification. Exploration funds, unlike other means sometimes employed to attract the same source of capital, are established with a view to acquisition and exploration of multiple properties, thereby spreading risk and opportunities. This is particularly important in view of the statistically remote chances of finding oil. One of the funds examined, for example, represented that it would use its best efforts to obtain and drill not less than ten drilling blocks annually.

Notwithstanding the similarities, the differences between exploration funds and mutual funds are more apparent. For example, an exploration fund is not an investment company under the Investment Company Act and hence not subject to

difficult. It would be even more difficult to borrow funds for the purpose of drilling a development well, because a substantial number of such wells are failures. See note 10 infra.

9. The technique of selling fractional undivided interests in a single undrilled well has often been used to finance oil and gas exploration through investments by high-bracket taxpayers. A partial exemption from registration for such offerings not exceeding $100,000 is provided by Regulation B, 17 C.F.R. § 250.310 (1967), and form S-19 is especially designed for the filing of such interests. See generally Bloomenthal, SEC Aspects of Oil and Gas Financ- ing, 7 Wyo. L.J. 49 (1958). The Securities Act Registration List, supra note 2, disclosed only one registration statement relating to such an offering. During the fiscal year ending June 30, 1965, 178 offering sheets were filed under Regulation B and aggregate sales reported thereunder were $1,603,144. SEC ANN. REP, 40 (1966-67).

10. During 1966 there were 9,214 exploratory wells drilled in the United States, of which 1,037 were completed as oil wells, 631 as gas wells, and 7,546 as dry holes. Thus, the total successful completion rate was 18.1%, or slightly better than one out of six. The success ratio varied from a low 8.7%, or slightly better than one out of 12, in California to a high of 44.6% in the northeastern United States—West Virginia, Pennsylvania, and New York. These statistics do not, of course, reflect the quality of the completions. During the same year 23,759 development wells were drilled, of which 6,011, or 25.3%, were dry. See 65 OIL & GAS J. 135, 146 (1967).
the same type of regulation as the mutual fund. Thus, many opportunities for self-dealing and potential conflicts of interest exist as to exploration funds which would be proscribed under the Investment Company Act.\textsuperscript{11} Moreover, investments are in mineral properties, not securities, and involve mineral operations rather than the passive holding of a portfolio of securities.\textsuperscript{12} Mutual funds have their primary appeal to relatively unknowledgeable, small investors; whereas investors in an exploration fund are likely to be—and should be—relatively sophisticated and affluent. Exploration fund "managers" have nearly unlimited discretion in the selection of properties while the manager of a mutual fund is subject to some limitations under the Investment Company Act and under the fund's policy as to the type of securities to be acquired. Finally, the exploration fund is typically a much more speculative investment than a mutual fund, largely tax motivated, and with substantially different objectives.

\textbf{Mineral Operations—Legal Aspects}

Since this article is intended to be in the nature of a primer, it may be helpful to discuss the legal framework in which mineral exploration generally takes place. Mineral operations of the type being discussed often involve lands in private ownership as to which there has been a severance of the surface and mineral rights. The owner of the mineral rights relating to oil and gas generally is not regularly engaged in the mineral business and hence is likely to enter into a lease for the exploration and development of his property.\textsuperscript{13} The oil and gas lease has become a fairly stereotyped agreement. Its specified duration is ordinarily for a relatively short term—usually 5 to 10 years—with a habendum clause which provides that the lease shall continue so long thereafter as oil and gas is produced in paying quantities on the lessor's property. Under the typical arrangement, the lessor reserves a royalty interest of normally twelve and one-half percent of gross income from the oil or gas produced. However, the lessee can usually avoid any obligation to explore

\textsuperscript{11} See text accompanying notes 149-53 infra.
\textsuperscript{12} Investments in mineral properties, however, may be "securities" as that term is used in the Investment Company Act of 1940. See text accompanying notes 146-49 infra.
\textsuperscript{13} For a discussion of private oil and gas leasing and the typical oil and gas lease see generally 3 H. Williams, Oil and Gas Law (1967).
the property during the primary term of the lease by paying an annual delay rental and, further, can surrender the lease and all obligations thereunder by failing to make such annual rental payments. If the property is considered desirable mineral acreage, the lessee, in order to acquire the lease, will generally have to pay the owner a cash consideration referred to as a "bonus" payment. After acquiring an oil or gas lease, the original lessee will very often assign the leasehold, retaining a so-called overriding royalty interest representing a specific percentage of the gross proceeds free from all costs of exploration, development, and operation. Since the leaseholder typically bears all such costs, his interest is often referred to as the working interest, reflecting the fact that the holder thereof has the exclusive right to explore and develop the leased property.

In the eleven westernmost states of the United States and in Alaska, much of the lands available for oil and gas exploration are part of the public domain and, thus, the right to explore, develop, and operate such properties can be obtained only pursuant to the Mineral Leasing Act of 1920.14 With respect to lands located on the outer continental shelf or within the geologic structure of a known producing oil and gas field, leases can be obtained only through competitive bidding. Leases on other available federal land, however, are issued to the first qualified applicant on a non-competitive basis. Non-competitive federal oil and gas grants are for a primary term of ten years with the typical habendum and delay rental clauses found in private leases. To acquire such an interest, the applicant must pay in advance a filing fee of ten dollars and the first-year rental of fifty cents per acre. Like private leasehold agreements, federal land leases can be allowed to lapse in subsequent years by failure to pay the annual rental. Since most desirable federal lands have already been leased, the non-competitive leases currently available are either those which a lessee has permitted to terminate by non-payment of rent or those which have expired at the end of the lease term because of a failure to obtain production. With respect to these lands, the Bureau of Land Management has

established simultaneous filing procedures which generally allow a five-day period in which all applicants may submit their lease offers. Since typically several applicants will have submitted the necessary offer within the requisite period, a drawing is held to determine the "winner" of the particular lease. Federal leases provide for royalties payable to the federal government in the amount of twelve and one-half percent with respect to non-competitive leases and a scaled royalty in the case of competitive grants.

The oil and gas industry also employs a variety of farm-out arrangements pursuant to which the owner of mineral rights assigns an interest therein in return for the drilling of a well. These arrangements are often motivated by a desire to share, and thus reduce, risks and/or the need for financial assistance. Although major oil companies farm out acreage to other major companies and to independents, the extent the grantors are willing to do so and the quality of the acreage assigned is dependent up their own exploration budget. Farm-out arrangements take many forms, such as an undivided interest in the acreage to be drilled, a divided checker-boarded interest, or a retained overriding royalty. Risk distribution may also vary. The assignee, for example, may be obligated for all the drilling and completion costs; or for only the drilling costs and his proportionate part of the completion costs. Moreover, he may have the right to recover his costs out of production.

Mineral rights relating to resources other than oil and gas vary somewhat from the procedures outlined above, since in the western states only a small portion of the desirable lands are in private ownership. To the extent that such lands are privately held, the leasing arrangements for carrying on general mineral operations will be similar in general outline to those employed with respect to oil and gas, although such leases are not nearly as stereotyped. Entirely different procedures are involved in acquiring metalliferous mineral rights with respect to government lands,15 since the mineral location laws rather than the Mineral Leasing Act are applicable. In general it is necessary to locate unpatented mining claims

15. On mining locations see generally 1 ROCKY MOUNTAIN MINERAL LAW FOUNDATION, AMERICAN LAW OF MINING 711-906 (1967); and F. TRELEASE, H. BLOOMENTHAL & J. GERAUD, supra note 14, at 415-613.
covering lands in the public domain, a task which in practice
is most likely undertaken by persons regularly engaged in the
business of carrying on mineral operations. Nevertheless, it
is not uncommon for the original locator to enter into some
type of lease or other arrangement with a more adequately
capitalized mining company. These arrangements differ con-
siderably depending upon the mineral involved and the
particular terms negotiated.

MINERAL OPERATIONS—TAX ASPECTS

The tax advantages of mineral operations include the
statutory depletion deduction which is twenty-seven and one-
half percent of gross income in the case of oil and gas, twenty-
three percent in the case of uranium, and ranges from twenty-
three to five percent with respect to other mineral property,
but cannot exceed fifty percent of net taxable income (with-
out regard for depletion) from such property. In the case
of minerals other than oil and gas, gross income from the
property is the income from "mining," which in many
instances is defined to permit a computation based on added
values to gross income reflecting such considerations as trans-
portation and milling costs. Accordingly, while the statutory
depreciation rate is itself lower with respect to minerals other
than oil and gas, the effective depletion rate may be higher,
since the value of petroleum resources for gross income pur-
poses must be computed at the well head.

The statutory depletion deduction, which can be taken
without regard to actual depletion and does not depend upon
the amount invested in the property, often exceeds the deple-
tion deduction based upon the actual cost investment in the

16. INT. REV. CODE OF 1964, § 613(b); Treas. Reg. § 1.613-2(a) (1960).
17. INT. REV. CODE OF 1954, § 613(b).
18. Id.
19. Id. § 613(c). See generally Bloomenthal, A Guide to Federal Mineral Income
20. The statutory depletion rate for uranium, for example, is 23%. Assuming
a crude ore price of $4.00 a pound, the depletion deduction would be $0.92
per pound. Yet, the integrated producer selling concentrate at $8.00 per
pound can compute statutory depletion on gross income, which in this
instance would be $1.94 per pound or approximately 48.5% of the value of
the crude ore. However, the provision limiting depletion to 50% of net
income will usually come into play and reduce somewhat the amount of
statutory depletion that can actually be taken under these circumstances.
mineral property.\textsuperscript{22} Depletable capitalized expenditures, therefore, seldom result in tax benefits.

Since the statutory depletion deduction is in effect a subsidy to the successful mineral operator whose efforts and risk-taking have resulted in production, it is undoubtedly a factor in channeling risk capital into mineral operations. However, it is probably not as important as the deductions for exploration and development costs in this regard. These latter deductions can be offset against current income from other sources and, therefore, are factors which make an exploration fund an extremely attractive investment. While it is not necessary in most cases to distinguish between oil and gas and other minerals when dealing with the depletion deduction, except as to the percentage rate and basis for determining gross income, the tax consequences differ significantly with respect to exploration and development expenditures for the various minerals. In the case of oil and gas, geological and geophysical exploration costs constitute capital expenditures and not ordinary and necessary business expenses.\textsuperscript{23} Hence, expenses incurred in geologizing an area, such as those resulting from seismic surveys, must be capitalized and recovered through the depletion deduction regardless of whether they were incurred for the purpose of determining whether to acquire a property initially or to retain a property previously acquired. Geological expenses "necessary in preparation for the drilling" and in the actual drilling are, however, within the optional deduction for intangible drilling and development costs discussed below. The line between geological surveys relating generally to a property and those relating to the location of a particular drill site is affected by a number of considerations. The IRS apparently employs the following criteria:\textsuperscript{24} (1) To relate to the location of a particular drill site, and hence to be within the option, the property must be one already acquired by the taxpayer. (2)

\textsuperscript{22} The principal items falling into the category of capital costs recoverable through depletion are acquisition costs, see Int. Rev. Code of 1954, § 1012; Treas. Reg. § 1.611-2(a) (1960), intangible drilling and development costs in the case of oil and gas, and exploration costs in the case of other minerals, if capitalized, see Int. Rev. Code of 1954, § 263(c); Treas. Reg. § 1.612-4(b) (1960).

\textsuperscript{23} Louisiana Land & Exploration Co., 7 T.C. 507 (1946), aff'd on other grounds, 161 F.2d 842 (5th Cir. 1947); I.T. 4006, 1950-1 Cum. Bull. 48.

\textsuperscript{24} Hall, Geological and Geophysical Costs, 16 Oil & Gas Inst. 581, 592-93 (1965).
Drill site surveys generally involve a relatively small expenditure and anything in excess of $3,000 to $4,000 is likely to be challenged. (3) Drill site surveys are usually followed shortly thereafter by actual drilling. (4) If the information gathered tends to outline a complete development, the geological work probably will not be recognized as having been undertaken to locate a drill site. (5) Drill site surveys are usually geological rather than geophysical.

Section 1.612-4(a) of the regulations of the Internal Revenue Service permit a taxpayer to elect to either capitalize intangible drilling and development costs or write them off as a current expense. Although from the standpoint of the geologist the drilling of an oil or gas well may involve either exploration or development, depending upon the extent to which the presence of an oil reservoir has been previously established, from a tax standpoint no such differentiation is made between the two activities. Rather, the optional deduction for intangible drilling and development costs in the case of oil and gas is predicated merely on the drilling of a well. In the event the election is made to capitalize such expenditures, they must be recovered through the depletion allowance, except that installation costs of physical (tangible) equipment must be amortized through the deduction for depreciation. Furthermore, the election for each taxpayer is binding as to all future intangibles.25 Thus, generally the election should be to deduct such expenditures.26 No election with respect to tangible expenditures is provided and, pursuant to section 1.612-4(c) of the regulations, all such expenditures must be capitalized and recovered through depreciation.

In general, intangible drilling and development costs are expenditures which yield no salvage value and are incurred in the drilling and preparation of wells for the production of oil or gas. Examples of items subject to the option are:

all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used—(1) In the drilling, shooting, and cleaning of wells, (2) In

25. Treas. Reg. § 1.612-4(e) (1965). The taxpayer who has capitalized intangibles on producing wells has a further identical election with regard to dry holes. See id. § 1.612-4(b)(4).
such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and (3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.\(^\text{27}\)

Expenditures incurred in the installation as well as construction of derricks, tanks, pipelines, and other physical structures necessary for the preparation of the well for production are within the option,\(^\text{28}\) but the cost of the physical installations themselves must be capitalized and recovered through depreciation.\(^\text{29}\) Accordingly, the cost of items having salvage value such as drilling tools, pipe, casing, tubing, tanks, engines, boilers, and pumps must be depreciated. It should be noted, however, that the Internal Revenue Service has taken a narrow view\(^\text{30}\) of what is involved in preparing a well for production and regards a well as completed for production when the casing, including the "Christmas tree,"\(^\text{31}\) has been installed.

The importance of the intangible deduction in providing capital to any oil and gas operator cannot be overemphasized. If, for example, the operator drills a well on a producing property and the intangible drilling costs incurred total $60,000, he can, if he has elected to deduct such costs currently, deduct this amount from the income received from this property or any other source. Assuming, for example, that the operator's taxable income before deducting intangibles is $300,000, by taking the intangible deduction he, in effect, receives $60,000 of this amount free of taxes. The net cost of the investment for a taxpayer in the highest bracket to the extent represented by intangibles (and assuming that he does not have other available deductions) is $18,000 [$60,000 less tax of $42,000 (70% × $60,000) otherwise payable = $18,000].

In the case of minerals other than oil and gas, the taxpayer has two basic alternatives with respect to exploration

\(^{27}\) Treas. Reg. § 1.612-4(a) (1965).
\(^{28}\) Id.
\(^{29}\) Id. § 1.612-4(c).
\(^{30}\) Mem. 6754, 1952-1 CUM. BULL. 30.
\(^{31}\) The "Christmas tree" is a group of flow control valves which are installed in a producing well after the casing and tubing but prior to the installation of the pump.
expenditures; an unlimited deduction under section 617 of the Code subject to recapture or a limited deduction under section 615 not subject to recapture. Under section 617 a taxpayer may currently deduct all exploration expenditures “paid or incurred . . . for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore or other mineral . . . , and paid or incurred before the beginning of a development stage of the mine . . . .” However, all exploration deductions taken under section 617 are subject to recapture and, thus, must be either restored to income in the year in which the property becomes productive or reclaimed by a reduction of the statutory depletion deduction relating to that property. If prior to recapture the taxpayer “subleases” the property, retaining an overriding royalty and receiving a cash bonus, the amount of statutory depletion that ordinarily can be taken with respect to a bonus must be reduced to the extent of such unrecovered exploration deductions. Further, statutory depletion cannot be taken on royalty payments until the balance, if any, of the exploration deduction has been recaptured. If the taxpayer makes a complete disposition of the property through sale, his gain on the sale will be ordinary income rather than capital gain to the extent that prior exploration deductions relating to the property have not been recovered.

With regard to expenditures incurred in the exploration of minerals other than oil and gas, the other basic alternative is to rely on the provisions of section 615 of the Code, which

33. Id. § 617(c). Mineral tax law makes some rather unique and fine distinctions between a sale transaction on the one hand and a lease or sublease on the other. If, for example, an owner assigns the lease to a producing lessee for a consideration of $100,000 and retains an oil payment, the transaction is a sale. However, if the retained interest is an overriding royalty, the transaction would be a sublease. See generally Bloomenthal, A Guide to Federal Mineral Income Taxation (pt. 2), 1 Land & Water L. Rev. 879, 881-91 (1966). For varying tax implications in this context see note 35 infra.
35. Id. The different methods for recapture could affect the form of a particular transaction. Assume there exists an uranium property with no basis but as to which $100,000 remains to be recaptured at the time of disposition. This property is to be “sold” for a consideration of $100,000 and a retained interest. If the retained interest is an oil payment—thus resulting in a sale—a total recapture can be made on the transaction. If, on the other hand, the retained interest is an override and the transaction is deemed a sublease, only 50% of $100,000, or $50,000, will be recaptured and $77,000 will remain to be recaptured from depletion attributable to royalty payments. See Bloomenthal, A Guide to Federal Mineral Income Taxation (pt. 1), 1 Land & Water L. Rev. 77, 186-91 (1966). Incomplete dispositions which are “sales” for tax purposes yield other interesting ramifications for recapture, but they are beyond the scope of this article.
in various forms has been in effect since 1951. However, the elections under sections 615 and 617 are mutually exclusive; and, accordingly, a taxpayer cannot proceed under one as to some properties and under its companion as to other properties. Under section 615 the taxpayer has the following elections: (1) He may deduct as an expense in his tax year up to $100,000 of such expenditures, provided, however, that all amounts previously or currently being deducted or deferred with respect to the particular mineral property or any other property do not exceed $400,000. (2) He may elect to defer such expenditures in any tax year to the extent of the difference between the amount, if any, deducted during such year and $100,000, subject to the same $400,000 overall limitation referred to in (1). In the event the taxpayer defers exploration expenditures, he may then write them off proratably against the ore body as it is produced. (3) The taxpayer may—and must to the extent the statutory limitations are exceeded—elect to capitalize such expenditures and recover them through the depletion deduction. Some tax counselors tend to confuse deferral and capitalization of mineral exploration expenditures. If these are deferred, a subsequent expense deduction is allowed against the production from the ore body discovered as a result of such expenditures. The taxpayer may also take depletion, which will ordinarily be at the statutory rate since exploration expenditures do not become part of the taxpayer’s basis for depletion purposes. However, when such costs are deferred, they become part of the taxpayer’s basis in the mineral property for purposes other than determining cost depletion. Alternatively, if the taxpayer capitalizes such expenses, they become part of his basis for all purposes, including the determination of cost depletion. Since statutory depletion frequently exceeds cost depletion, the capitalization of such costs often does not result in a tax benefit.

37. Id. §§ 615(a)-(c) (1).
38. It is, of course, conceivable that with respect to high cost properties, cost depletion will exceed statutory depletion. In addition, if the property is sold, amounts capitalized will reduce any gain or increase a loss. Further, if a property is abandoned, an ordinary loss deduction may be taken for any amounts capitalized. See text accompanying notes 49-53 infra. However, the IRS has adopted an approach with respect to capitalized exploration expenditures which generally precludes claiming any loss until all of the properties benefited by such expenditures have been abandoned. See I.T. 4066, 1950-1 Cum. Bull. 48; Bloomenthal, A Guide to Federal Mineral Income Taxation (pt. 1), 1 Land & Water L. Rev. 77, 163-66 (1966).
In contrast to the deduction for intangibles relating to oil and gas operations discussed above, section 615 elections can be made for separate properties, can be made in whole or in part, and can differ in each tax year. A taxpayer could, for example, deduct $10,000, defer $50,000, and capitalize $20,000 of exploration expenditures in one tax year even though incurred with respect to the same property. In a following year he could make entirely different elections.

Should the taxpayer receive property through certain types of non-taxable transfers, including a transfer for stock in a controlled corporation or in connection with a tax-free corporate merger or other reorganization, all exploratory expenditures previously deducted or deferred by the transferor or must be included in determining the transferee's $400,000 limitation. Under section 1.615-4 of the regulations, such amounts must be included, even if expended by the transferor on properties other than those transferred to the taxpayer.

The section 617 alternative with respect to exploration expenditures was added in 1966 because of congressional concern that many taxpayers had exhausted or were close to exhausting the aggregate limits under section 615. For taxpayers who have not exhausted such limits or are not close to doing so, the logical procedure in most instances, in view of the structure of the provisions and of the elections thereunder, would be to initially elect to be taxed under section 615. A taxpayer may, within three years after making such an election, revoke his choice and, in effect, retroactively elect for prior as well as future years to proceed under the provisions of section 617. On the other hand, if a taxpayer initially chooses to proceed under section 617, his election will be irrevocable once final regulations are adopted under this section. An additional factor to consider is that section 615 is applicable to exploration expenditures regardless of

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40. Id. §§ 362(b), 368(a).
41. Id. §§ 615(c)(2)-(3).
44. INT. REV. CODE OF 1954, § 615(c).
45. The election cannot be revoked more than three months after the adoption of the final regulations under § 17. See id. § 617(a)(2)(b). As of the date of this writing (January 20, 1968), final regulations had not been adopted and hence calendar year taxpayers electing § 617 treatment for 1967 will still have a period of time in which to revoke their election.
where incurred, whereas section 617 is applicable only with respect to exploration expenditures incurred on properties located within the United States or on its outer continental shelf.46 Thus, if a taxpayer with substantial mineral operations outside the United States elected to proceed under section 617, he could not deduct exploration expenditures on such properties.

A corporation has its own election to make between sections 615 and 617 and is subject to $100,000 and $400,000 limitations under section 615 separate from those imposed on its shareholders.47 However, as previously noted, prior transfers to the corporation in nontaxable transactions may affect the extent to which the aggregate limit is available to the corporation. Similarly, each participant in a partnership can make his own election between sections 615 and 617, and each partner has his own separate aggregate and annual limitations under the provisions of section 615.48

A final deduction which is relevant to mineral operations is the deduction for losses "incurred in a trade or business or . . . in any transaction entered into for profit although not connected with a trade or business."49 Losses of this type can be offset against ordinary income50 and hence have a distinct advantage over a long-term capital loss. In order to qualify for this deduction, the loss must be bona fide and "evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year."51 The fact that an asset has lost all of its value is a closed and completed transaction for this purpose.52 Events establishing such worthlessness with respect to mineral properties usually involve drilling a dry hole in the case of oil and gas, or comparable unsuccessful drilling or exploratory work for other minerals, preferably, but not necessarily, accompanied by abandonment of the mineral property involved.53

46. Id. § 617(a) (1).
47. A corporation is generally a separate tax entity. See id. § 11(a).
48. Id. § 703(b).
49. Id. §§ 165(c) (1)-(2).
50. Id. § 165(a).
52. Cf. C.C. Harmon, 1 T.C. 40 (1942), aff'd on other grounds, 139 F.2d 211 (10th Cir. 1944), rev'd on other grounds, 323 U.S. 44 (1944).
The seven exploration funds examined all stressed the tax benefits to be derived from the statutory depletion deduction and the optional deduction relating to intangible drilling and development costs. Some of them also referred to the deduction for worthlessness. In addition, all but one of the prospectuses set forth the tax consequences in the form of an opinion of counsel and in reliance on counsel as an expert. Moreover, the prospectuses also unequivocally stated that in the opinion of counsel, the "venture" would not be classified as an association taxable as a corporation—a determination which is critical to passing the deductions directly through to the investor. This aspect of the tax problem, and the sponsors' tax problems arising out of the interest received by them, are discussed in succeeding sections.

FORM OF ORGANIZATION—IN GENERAL

The agreements and arrangements employed by the seven exploration funds generally reflect a high degree of professional competence on the part of counsel. Indeed, such skill and ingenuity is requisite to achieving the following tax objectives of the exploration fund: (1) the investors should be permitted to take all of the deductions; (2) the investors should bear the tax on all the income during "payout"; and (3) the sponsor-manager should receive its interest in a nontaxable transaction.

A listing of the legal frameworks available for an exploration fund would include the following:

(1) A fund could be organized as a corporation and could issue the usual equity securities. If there were less than ten shareholders involved and certain other requirements were met, the corporation may elect Subchapter S taxation. Such a corporation would not differ substantially from other oil and gas or mining companies which propose to engage primarily in the acquisition and exploration of mineral proper-

54. See text accompanying notes 70-98 infra.
55. See text accompanying notes 99-141 infra.
56. Int. Rev. Code of 1954, § 1371(a). To be eligible to make a Subchapter S election, the corporation must not: (1) have more than 10 shareholders; (2) have as a shareholder a trust, corporation, or person (other than an estate) who is not an individual; (3) allow its shares to be held by a non-resident alien; or (4) issue more than one class of stock. Id.
ties. However, since the use of a Subchapter S corporation is limited to a fund with ten or less investors, it is generally unavailable if securities are to be publicly offered.

(2) A fund could be organized as a limited partnership with the sponsor acting as the general partner and the investors as limited partners.

(3) A fund could be organized as a limited partnership as in (2) with the limited partners as a group constituting a separate Subchapter S corporation.

(4) A fund could be organized as a general partnership. The partners would be in all probability be few in number, consisting only of the organizers. The organizers in turn would offer and assign portions of their interests in partnership profits without having their assignees substituted as partners.57

(5) A fund could be organized so that each of the participants in the fund held tenancies in common in any mineral properties acquired. The co-owners could then enter into an operating agreement designating the sponsor as "operator" and specifying the respective rights and obligations of the parties.

(6) A fund could be organized as a "mining partnership" with the sponsor designated as managing partner.

The foregoing represents the principal alternatives for organizing an exploration fund, although obviously there are numerous variations with respect to each. Of the seven funds examined, three employed limited partnership arrangements and four, while variously styled and differing in detail, involved basically complicated co-ownership arrangements with operating agreements.

FORM OF ORGANIZATION—THE CORPORATION

The corporation, generally the most favored form of business organization, is something of a stepchild in a mineral exploration program designed to maximize tax advantages

57. Nonsubstituting assignments would not terminate the partnership. UNIFORM PARTNERSHIP ACT § 27(1). Only the death of the original partners and not that of the assignees would terminate the partnership. Id. § 31(4).
for the benefit of high-bracket taxpayers. The reasons for this are at least threefold: (1) the usual double tax disadvantage involved in the use of a corporation; (2) the fact that a distribution of depletion reserves is taxed as a dividend rather than a return of capital to the extent statutory depletion exceeds cost depletion;\textsuperscript{58} and (3) the fact that the corporation form ordinarily does not permit tax deductions to be passed through to the shareholders. The typical investor in an exploration fund is looking for his own tax deductions during the current year. The fact that the corporation may have such tax deductions will not accomplish his objectives, particularly if the entity has no offsetting income. Further, if the exploration is successful, cash distributions to him will be taxable to the extent statutory depletion exceeds cost depletion, depriving him in large part of the benefit of the statutory depletion deduction. Finally, if the venture fails, the loss resulting from the sale of his corporate shares or from the worthlessness of the shares will be a capital rather than an ordinary loss.\textsuperscript{60}

If a private placement of fund shares is contemplated, a fund organized as a corporation may be able to utilize Subchapter S and section 1244 to accomplish the desired tax objectives. To achieve a Subchapter S election, of course, participants must be limited to ten individual shareholders. Assuming that Subchapter S is utilized, the deductions and losses generated by the corporation can be passed through to its shareholders.\textsuperscript{60} In subsequent years the shareholders may find it advantageous to revoke the election,\textsuperscript{61} keeping most of the earnings in the corporation and allocating the cash generated through the depletion reserve for further exploratory ventures. In addition, a corporation could also issue section 1244 stock up to an aggregate of $500,000. To the extent section 1244 stock is used, any loss realized as a result of the sale of worthlessness of the stock can be taken as an ordinary

\textsuperscript{58} Treas. Reg. § 1.316-2(e) (1956).
\textsuperscript{59} INT. REV. CODE OF 1954, §§ 165(f)-(g).
\textsuperscript{60} Id. § 1374.
\textsuperscript{61} Revocation may be effected if consented to by all the shareholders. See id. § 1372(e) (2). A Subchapter S corporation with exploration deductions subject to recapture under § 617, see text accompanying note 32 supra, may find it advisable to revoke its election in the year in which income is to be restored, since taxation of such restored income at corporate rates would probably yield less tax liability than taxation at individual rates.
loss.\footnote{62} However, the $500,000 limitation, along with other section 1244 requirements,\footnote{63} might undesirably limit the size of the fund.

Subchapter S fails to remove one serious disadvantage of the corporate form; \textit{i.e.}, distribution of depletion reserves will generally be taxed as a dividend to the extent statutory depletion exceeds cost depletion. Nevertheless, if such reserves are not distributed, they do not constitute part of the corporation's undistributed net income for the purpose of determining a shareholder's taxable share of corporate income.\footnote{64} Accumulation of depletion reserves in anticipation of further exploration may be feasible in the case of a relatively close-knit group interested in ultimately building a producing company. Presumably the investor-shareholder would benefit from the corporate growth through the sale of his shares or possibly upon the ultimate dissolution of the corporation, both of which events would yield capital gain treatment. It is essential, however, that the collapsible corporation provisions of the Code\footnote{65} be avoided both with respect to sales of shares by any participant with a greater than five percent shareholding and upon liquidation of the corporation. Generally these provisions do not pose problems for companies developing mineral properties unless particular shareholders can be classified as "dealers" for tax purposes. However, if a shareholder-investor has been involved in other mineral operations, he might find himself possessing the condemning

\footnote{62} \textsc{Int. Rev. Code of 1954, § 1244 (a).}

\footnote{63} Section 1244 (c) requires a plan under which stock is to be issued within two years of its adoption. Further, the total of the equity capital of the corporation on the adoption date and the aggregate amount to be issued under the plan must not exceed $1,000,000.

\footnote{64} \textsc{Int. Rev. Code of 1954, §§ 611, 1373 (b)-(d).}

\footnote{65} \textit{Id.} § 341. This provision converts what would be capital gain on some sales of stock or liquidation into ordinary income and also limits the utilization of § 333 and § 337 liquidations. A corporation with undeveloped properties on which oil is discovered is likely to be a "collapsible corporation" within the definition of § 341 (b) (1). \textit{See Honaker Drilling, Inc. v. Koehler, 190 F. Supp. 287 (D. Kan. 1960).} However, sales of stock by distributions in liquidation to shareholders owning less than 5\% of the stock are, in effect, excluded from the application of § 341 by the provisions of § 341 (d). Further, if the corporation's net unrealized appreciation in § 341 (e) assets does not exceed 15\% of the corporation's net worth, and if no shareholder owning more than 20\% of the outstanding stock is a "dealer," the collapsible operation provisions will be inapplicable for most purposes. Generally, § 341 (e) assets are these items such as inventory which produce ordinary income when sold. Hence, an exploration and development company would not have substantial assets of this nature unless it also traded in leases and other mineral rights. For an excellent discussion of the complex collapsible provisions see \textit{generally Pye, How To Avoid the Section 341 Trap in Disposing of Oil and Gas Interests, 1967 P-H Oil & Gas Taxes} \S 4012.
qualifications. This could be particularly true of the manager-sponsored, assuming that he is a shareholder, or some of the shareholder-investors who may have been tempted to participate in simultaneous drawings relating to federal oil and gas leases. Moreover, the acquisition of such leases with a view to reselling them to major oil companies is very likely to yield dealer classification.

Even with a Subchapter S qualification, the corporate form may be less desirable for a fund engaged in exploration for minerals other than oil and gas. If such a corporation utilized section 615, it would be subject to a single $100,000/$400,000 limitation, whereas if the fund were organized as a partnership, each partner would have a separate $100,000/$400,000 limitation, thus permitting a greater exploration deduction for the same "venture." However, if some of the individual shareholders had exhausted the section 615 limits, the organization of a new corporation would create a new section 615 deduction. Of course, the corporation might find it advantageous to rely on the section 617 deduction.

Finally, if the manager-sponsor is an individual, it may be feasible for him to become a shareholder in the Subchapter S corporation. If, as is more likely, the manager-sponsor is a corporation, it would have to remain outside of the Subchapter S entity in order to preserve the favored tax treatment. Thus, there may be certain advantages in the utilization of a limited partnership consisting of the sponsor as general partner and the Subchapter S corporation as the limited partner. This approach is discussed further below.

Despite the tax difficulties attendant utilization of the corporate form, it has many well-known advantages as a vehicle for carrying on mineral operations, such as limited

66. For a discussion of federal oil and gas leases see text accompanying note 13 supra. Since original acquisition costs are deductible, e.g., Commissioner v. Miller, 227 F.2d 326 (9th Cir. 1955); United States v. Dougan, 214 F.2d 511 (10th Cir. 1954), some high-bracket taxpayers are tempted to play the federal "lottery."


68. See text accompanying notes 37-48 supra.

69. See text accompanying notes 135-41 infra. Presumably a preferable arrangement would allow the sponsor to become the general partner and the individual investors limited partners. See note 61 supra, however, for one situation in which the use of a separate corporation as a limited partner may be advantageous.
liability, free transferability of interests, convenience of centralized management, relative liquidity for investors, perpetual existence, continuity of existence, and well established legal doctrines defining the relationships, obligations, and rights of the participants.

**Form of Organization—Co-Owners Joint Operating Agreement**

In the past co-ownership operating agreements have typically related to the development of a specific property in which the investors become co-tenants by acquiring fractional undivided interests and then designate one of the co-owners as operator.\(^7\) Because of the widespread use of such agreements, particularly in connection with farm-outs, they have become reasonably standardized. Nevertheless, the four exploration funds employing this device have utilized some ingenious adaptations.\(^8\) The exploration fund usually has no properties at its outset. Thus, a contractual agreement is entered into under which the investors agree to advance funds and the sponsor agrees to acquire and drill oil and gas properties with such funds. Once a property is acquired, the investor becomes co-owner of the property and operations are carried on under a more or less standard operating agreement designating the manager as operator. Title to properties is generally taken in the name of a nominee, although at least one fund agrees to assign to the investor his fractional undivided interest upon demand.

One explanation of the popularity of such arrangements is the fact that each co-owner can take his proportionate share of the deductions. However, it is essential that the group of co-owners avoid classification as an association which is taxable as a corporation. Absent an organization utilized for joint-profit purposes, there is no association.\(^9\)

\(^7\) Co-ownership operating agreements may result from the sale of undivided interests for the purpose of raising funds to explore a specific property, see note 9 supra, or from a farm-out arrangement under which the owner of a lease, for example, conveys an undivided one-half interest in return for the assignee’s commitment to drill a well at the assignee’s expense and risk.

\(^8\) The three funds examined which were organized as limited partnerships also utilized standard operating agreement arrangements between the limited partnership and the party responsible for carrying out drilling activities, who was usually an affiliate of the sponsor.

\(^9\) The Code defines a corporation to include “associations,” INT. REV. CODE OF 1954, § 7701(a)(3). “Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged
administrative rulings of the IRS, the question of whether co-owners have joint-profit objectives is determined by the arrangements relating to the marketing of mineral production.78 Thus, practitioners have assumed that considerable, if not complete, control can be vested in the operator in carrying on the mineral operation provided each individual co-owner retains control over the disposition of his share of production. Standard provisions designed to accomplish such a result recite that each co-owner reserves the right to receive his proportionate share of production in kind, and that until the exercise of such right, the operator shall have revocable authority as the co-owner’s agent to dispose of production and to enter into contracts for the sale of production provided such contracts do not exceed the minimum needs of the industry and in no event are for a period in excess of one year. The operator may have similar revocable authority from other non-operators without condemning the “entity” as an association. If, however, the operator has irrevocable authority from two or more co-owners to dispose of production, or has revocable authority permitting him to contract for periods exceeding the minimum needs of the industry or one year, whichever is less, the entity will be considered an association and hence taxed as a corporation.

All of the four funds utilizing this type of arrangement contained the standard provisions giving each co-owner “control” over his share of production. The fund agreement, however, enhances the control usually exercised by the operator by designating him manager of the fund, for this position generally grants him unlimited discretion as to the acquisition, exploration, and operation of mineral properties. Yet, all four prospectuses included opinions of counsel that the arrangement was not an association taxable as a corporation, and two of them referred to prior favorable rulings from the IRS with respect to similar funds. Nonetheless, the investor-co-owner’s mere theoretical right to control the disposition of his share of production provides at best an unstable basis for the conclusion that a pooling of funds by several investors

with a sponsor who has such unrestricted control is not a joint-profit enterprise. One Tenth Circuit decision, for example, has looked through the somewhat artificial assumptions behind the administrative rulings and concluded that the co-ownership arrangement there in question was an association subject to taxation as a corporation, even though for the most part it complied with the IRS's pronouncements. The Service, however, has never repudiated these rulings and has generally shown a disposition to depart from them only in those instances in which complete compliance was questioned.

Assuming that a co-ownership arrangement can avoid classification as an association, it will be taxed as a partnership unless the co-owners elect to be treated as joint owners, taxed individually and not as partners. All of the operating agreements utilized by the four funds examined above made the appropriate election for exclusion from the partnership provisions (Subchapter K) of the Code.

FORM OF ORGANIZATION—PARTNERSHIPS

The partnership, particularly a limited partnership, is in many respects an ideal form of organization for an exploration fund and, as previously noted, three of the seven funds examined were limited partnerships. If, however, the tax advantages of utilizing the partnership form are to be realized, it is essential that the partnership not be classified as an association taxable as a corporation. Under the formula set forth in the current regulations, neither the typical general partnership nor the typical limited partnership organized under the Uniform Partnership and Uniform Limited Part-

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76. Bentex Oil Corp., 20 T.C. 565 (1953); I.T. 2785, XIII-1 CUM. BULL. 96 (1934). See also Rev. Rul. 54-84, 1954-1 CUM. BULL. 284. If the co-ownership arrangement is taxed like a partnership, it is important that the "partnership" make the appropriate election to deduct intangibles. See text accompanying notes 22-37 supra. If election is not made by the partnership, the individual partners will have to capitalize such expenditures.
78. Although § 7701(a)(2) of the Code presents a definition of "partnership," this separate treatment does not preclude the application of § 7701(a)(3) which defines a "corporation" to include "associations." See Treas. Reg. § 301.7701-8(b) (1960).
nership Acts is such an association.\textsuperscript{79} Furthermore, these regulations appear to be motivated by a desire to deny professional associations corporate status for tax purposes.\textsuperscript{80} Nonetheless, a careful practitioner may wish to adopt additional safeguards in drafting a limited partnership agreement to guard against the condemning classification. It is believed that the inclusion of the following provisions will be helpful for this purpose:

(1) Termination of the partnership within a specified period of time. This may be coupled with another provision that the partnership shall continue thereafter on a year-to-year basis with the general partners having the right to terminate at the end of each year upon giving advance notice.

(2) Termination of the partnership in the event of death, insanity, withdrawal, or bankruptcy of a general partner. This may be coupled with a provision that the partnership may continue with unanimous consent of the limited and general partners.

(3) Unrestricted withdrawal rights for general partners. This is an aspect of (2) above.

(4) Termination of the partnership upon assignment of the interest of a general partner. This may be coupled with a provision that such an assignment may be made with unanimous consent.

\textsuperscript{79} The critical characteristics of a corporation under the IRS formula are: (1) continuity of life; (2) centralization of management; (3) limited liability; and (4) free transferability of interests. To be classified as an association the organization must have more corporate characteristics than noncorporate characteristics. Tres. Reg. § 301.7701-2(a) (3) (1960). Thus, the regulations provide that centralized management does not exist in a limited partnership organized under the Uniform Limited Partnership Act unless substantially all of the partnership interests are owned by the limited partners. Id. § 301.7701-2(c) (4). The regulations also provide that personal liability does exist as to the general partner in such a limited partnership unless he has no substantial assets other than his interest in the partnership and he is merely a "dummy" acting as agent of the limited partners. Even if he were such a "dummy," the limited partners would have personal liability. Id. § 301.7701-2(d) (2). Accordingly, a limited partnership, which does not ordinarily have centralized management or limited liability, is not an association under the formula.

\textsuperscript{80} The refusal to extend corporate status to professional associations is, of course, an attempt to deny such organizations the benefit of qualified pension and profit sharing plans under Subchapter D of the Code. In view of the liberalization of the tax laws relating to comparable Keogh plans for the self-employed, this motivation has disappeared in part, although not entirely. See Keogh-Smathers Act, 76 Stat. 809 (1962) (now Int. Rev. Code of 1954, §§ 401, 404).
The purpose of the foregoing provisions obviously is to preclude the partnership from having continuity of existence and free transferability of interests. Undoubtedly, practitioners will differ as to the necessity for including all of these provisions. 81

Unlike the corporate form of organization, the partnership alternative avoids the taxation of distributed statutory depletion reserves. 82 First, partnership distribution in excess of basis are taxed, but only at capital gain rates. 83 Secondly, and most important, each partner’s basis in the partnership is increased ratably to the extent statutory depletion exceeds cost depletion. 84 Accordingly, in most instances the distribution of depletion reserves merely reduces the basis by a corresponding amount and, hence, is not taxable.

The use of the partnership form generally will permit the investors in an exploration fund to derive the benefit of tax deductions which would not have passed through the corporate form. While depletion will be taken by the partnership, the effect is to reduce the individual partner’s share of partnership taxable income. Further, as noted above, distribution of depletion reserves can ordinarily be made to the partners without adverse tax consequences. Moreover, the deduction for intangible drilling and development costs incurred in preparing oil and gas wells is taken directly by the individual partners. 85 Yet, it is important to note that the election to

81. If the sponsor-manager/general partner retains only an interest in profits, it might be argued, though not very convincingly, that centralized management exists on the theory that the limited partners own substantially all of the interests in the partnership. See note 79 supra. However, notwithstanding the statement in the regulations that a limited partnership does not ordinarily possess centralized management, see id., the limited partnership exemplifies the regulation’s general definition of that characteristic: “An organization has centralized management if any person (or any group of persons . . . ) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed.” Treas. Reg. § 301.7701-2(c)(1) (1960). Paragraph (1) of the text is probably not sufficient to avoid “continuity of life” unless coupled with paragraph (2). See id. § 301.7701-2(b) (1). In addition to paragraph (1) of the text, which relates to free transferability of interests, it may be desirable to limit assignments by the limited partners, since with such limitations it is clear under the regulations that free transferability does not exist. If interests can be transferred subject to a right of first refusal, “a modified form of free transferability exists” which will be accorded less significance in determining association classification than if present in an unmodified form. See id. § 301.7701-2(e). In the author’s judgment, it is advisable to take all possible precautions to avoid association classification.

82. See text accompanying note 68 supra.

83. INT. REV. CODE OF 1954, §§ 731(a) (1), 741.

84. Id. § 705 (a) (1) (c).

deduct these costs must be made by the partnership,\(^{86}\) and the failure of the partnership to elect such a deduction in the appropriate year will result in the capitalization of these expenditures.\(^{87}\) Until the 1966 amendments adding section 617 of the Code, the partnership was similarly to elect whether exploration expenditures relating to minerals other than oil and gas were to be deducted or capitalized; but the individual partners took such deduction directly into their own tax accounting.\(^{88}\) However, with the advent of section 617, the individual partners also make their own separate elections under sections 615 or 617.\(^{89}\) As previously noted, one of the advantages of a partnership over a corporation in this regard is the flexibility with respect to such elections, for each individual partner is subject to separate limitations under section 615,\(^{90}\) while those involved in an incorporated enterprise are allowed only one ceiling, that which can be taken by the entity. The deduction for development expenditures relating to minerals other than oil and gas is taken by the partnership, but, as in the case of the depletion deduction, this has the effect of reducing each partner's distributive share of partnership taxable income.\(^{91}\)

The extent to which the partnership form permits flexibility in allocating deductions to the investors is discussed at some length below in connection with the related problem of

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86. INT. REV. CODE OF 1954, § 703(b).
88. Treas. Reg. §§ 1.702-1(a) (8), 1.703-1(b) (1956).
89. INT. REV. CODE OF 1954, § 703 (b) : "Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership . . . and any election under section 615 . . . or under section 617 . . . shall be made by each partner separately."
91. As is well known, a partnership as such is not subject to tax, although the partnership computes its taxable income and files an information return. Rather, the individual partners are taxed on their distributive shares of partnership taxable income. INT. REV. CODE OF 1954, §§ 701-704. Since development expenditures are not among those items which § 702 requires each partner to take into account separately, they are considered in determining the taxable income of the partnership. As to minerals other than oil and gas, development expenditures such as stripping costs and the cost of sinking a shaft can be deducted, deferred, or capitalized in much the same manner as exploration expenditures under § 615, see text accompanying notes 22-48 supra, but there is no limit on the amount that can be deducted or deferred, see INT. REV. CODE OF 1954, § 616. While such development deductions are important with respect to the development of established ore bodies, they are not likely to play an important role in the formative stage of exploration fund and hence have not been emphasized in this article. For a discussion of § 616 see generally Bloomenthal, A Guide to Federal Mineral Income Taxation (pt. 1), 1 LAND & WATER L. REV. 77, 121-24 (1966).
the tax consequences of the sponsor's acquisition of an interest in the mineral properties.92

FORM OF ORGANIZATION—THE MINING PARTNERSHIP

The mining partnership is a distinct and somewhat unique form of business entity which developed to meet the needs of prospector-oriented financing of the early mining days in the West.93 While it is possible that co-ownership arrangements may result in inadvertent classification as a mining partnership for certain purposes,94 it is also conceivable that the organizers of an exploration fund might deliberately create such an arrangement. A mining partnership differs from a general partnership in that the death, insanity, or bankruptcy of a partner does not terminate the partnership; interests may be freely assigned with the assignee of a partnership interest substituted as a partner; a majority in interest can bind the dissenting partners, while individual partners have no authority to bind the partnership; and, although the managing partner has considerable inherent authority in the conduct of partnership affairs, this authority is said to be less than that possessed by a managing partner in an ordinary partnership.95 A mining partnership may not, however, be an attractive vehicle for organizing an exploration fund, since investors will be subject to unlimited liability.96 Also, this form is more likely to be characterized as an association taxable as a corporation than is a limited or general partnership. Since there exists free transferability of interests, continuity of life, and a form of centralized management, only one of the four characteristics—limited liability—of a corporation which the IRS regards as significant is missing. Thus, under the IRS formula that an organization will be classified as an association when it has more corporate than non-corporate characteristics, the ordinary mining partnership would appear to be an association taxable as a corporation.97 Appropriate

92. See text accompanying notes 128-41 infra.
93. See generally 4 ROCKY MOUNTAIN MINERAL LAW FOUNDATION, AMERICAN LAW OF MINING §§ 22.27-47 (1960). California, Idaho, and Montana have statutory provisions relating to mining partnerships but generally these statutes are largely declaratory of the "common law." Id. 22.31. It is interesting to note that mining partnerships also have English antecedents. See generally Kahn v. Smelting Co., 102 U.S. 641, 945 (1880).
94. See text accompanying notes 211-12 infra.
95. 4 AMERICAN LAW OF MINING, supra note 92, §§ 22.33-40.
96. Id. §§ 22.44-.45.
97. See note 79 supra.
drafting, however, might limit continuity and/or transferability, with the result that the four crucial elements would be equally balanced. Such drafting may be sufficient to avoid association classification, particularly in view of the informal structuring of centralized management in a mining partnership. Nevertheless, the practitioner would be well advised to obtain a ruling from the IRS before relying on this form with the expectation that condemning classification can be avoided. Finally, it should be noted that a partnership engaged in mining activities is not per se a “mining partnership.” However, in utilizing a partnership form for an exploration fund, it may be advisable to provide expressly that the partnership either shall or shall not be deemed a mining partnership.

ALLOCATING DEDUCTIONS TO INVESTORS AND THE EFFECT ON THE SPONSOR’S INTEREST

The seven funds examined all attempted to allocate the deduction for intangibles to the investors, which necessarily affects the type of interest to be received by the sponsor. The arrangement most favored was to provide that the sponsor’s interest in the properties should be in the nature of a “carried interest.” Under this arrangement the sponsor is not entitled to any part of the proceeds from production until the investors have received all costs of drilling, completing, and operating the well. Thereafter, the sponsor receives his designated share of production and pays his proportionate share of operating costs. Two of the funds granted the sponsor a net operating profit interest. Since under such an arrangement expenditures for drilling and completing the well are not included as costs in determining net operating profits, the sponsor is permitted to participate immediately in proceeds from production. One of the funds retained a small overriding royalty percentage which could be converted after payout into a net profit interest percentage. It is interesting to note that in the three limited partnerships in which the general partner was the sponsor, participation in the venture

98. There would appear to be little purpose in forming a mining partnership, and presumably a limited partnership would be a preferable vehicle. About the only advantage from the standpoint of the investors is that the mining partnership would offer them some participation in the management of partnership affairs.
was achieved by the grant of a property interest rather than a share of partnership profits.\textsuperscript{99}

The arrangements employed by the seven funds seem to be well designed to achieve the reasonable objective of the parties that investors retain the deduction for intangibles and pay tax on all the income received by them during payout. However, the arrangements may result in receipt by the sponsor of taxable income to the extent of the value of the interest he received. Further, because of the unsettled tax lore relating to carried interest arrangements, minor differences in form may upset the tax planning objectives. The following are illustrative of the difficulties encountered by plans utilizing a carried interest:

(1) Under one arrangement, usually characterized as a Manahan\textsuperscript{100} carried interest, $L$, the owner of the lease, assigns the entire lease to $O$, the operator, with a provision to the effect that upon complete payout\textsuperscript{101} a one-half interest in the lease is to revert to $L$. Under this arrangement $O$ reports one hundred percent of the proceeds as taxable income during payout and takes one hundred percent of the deductions. These are the tax consequences that the IRS appears to favor, and hence it usually is contending for a Manahan approach. Proposed regulations, since withdrawn, relating to the deduction for intangibles expressly adopted an approach that is compatible with this result.\textsuperscript{102}

(2) Under a second arrangement, referred to as an Abercrombie\textsuperscript{103} carried interest, $L$ assigns to $O$ a fifteen-sixteenths interest in a lease which provides that $O$ is to be entitled to

\textsuperscript{99} For a possible explanation of why this was done see notes 128-29 infra and accompanying text. One of the three limited partnership funds retained an overriding royalty in the property, but created a hybrid by providing that its income from this source would be its share of partnership profits. Another of the funds retained no interest in the exploratory well drilled, but received a working interest in the adjoining acreage.

\textsuperscript{100} Manahan Oil Co., 8 T.C. 1159 (1947). The actual facts of this case differed from those presented in the text in that the holder of the lease assigned only one-half of this interest and permitted the assignee to receive the income and take the deductions attributable to an additional one-fourth of the assignor’s original interest until the payout was completed.

\textsuperscript{101} “Payout” occurs at the point of time at which the cumulative aggregate net revenues from operations are precisely equal to the drilling and completion costs.


\textsuperscript{103} Commissioner v. J.S. Abercrombie Co., 162 F.2d 338 (6th Cir. 1947).
all of the proceeds during the payout period. In Commissioner v. J. S. Abercrombie Company,\textsuperscript{104} the Fifth Circuit held that $O$ had in effect made a loan to $L$ of the amounts advanced to pay $L$'s proportionate share of the cost. Hence, the proceeds attributed to $L$'s interest during payout, although actually received by $O$, were taxable to $L$. It follows from this approach that $L$ can deduct his proportionate share of the intangibles. The Fifth Circuit has held that $L$ can take such a deduction at the time of the expenditure, even though there is no guarantee that production from the well will be sufficient to assure payout.\textsuperscript{105} However, Weinert v. Commissioner,\textsuperscript{106} a more recent Fifth Circuit decision, suggests that this court is about to abandon Abercrombie and adopt the Manahan approach in this situation as well. Interestingly enough, although the Commissioner at one time acquiesced in Abercrombie,\textsuperscript{107} he has generally argued for a Manahan\textsuperscript{108} result, probably because of his occasional lack of success with the Abercrombie approach.\textsuperscript{109} The withdrawn proposed regulations dealing with intangibles gave what is in effect an Abercrombie example and applied to this example the Manahan result.\textsuperscript{110}

(3) Under a third arrangement, the Herndon\textsuperscript{111} carried interest, $L$ assigns to $O$ both a one-half interest in the lease and an oil payment to be made out of one hundred percent of $L$'s reserved interest until $O$ has recovered therefrom the amount of $L$'s share of drilling, completion, and operating costs. The assumed result under this approach has been to permit $O$ to deduct only one-half of the intangibles; to deny $L$ the right to deduct any intangibles, since they are not incurred by him; and to tax $O$ on one hundred percent of the proceeds, half of which $O$ receives from his undivided interest and the balance of which is received from the oil payment.

Between 1956 and July 15, 1965, the Internal Revenue Service had under consideration proposed regulations which

\textsuperscript{104} Id.
\textsuperscript{105} Prater v. Commissioner, 273 F.2d 124 (5th Cir. 1959).
\textsuperscript{106} 294 F.2d 750 (5th Cir. 1961).
\textsuperscript{107} 1949-1 CUM. BULL. 1.
\textsuperscript{108} See Weinert v. Commissioner, 294 F.2d 750, 757 n.14 (5th Cir. 1961).
\textsuperscript{109} Id.
\textsuperscript{111} Herndon Drilling Co. v. Commissioner, 6 T.C. 628 (1946).
would have eliminated in large part the uncertainty relating
to carried interests and other sharing arrangements. The
proposed regulations as revised in 1960 made it clear that, in
a Manahan type carry, the carrying party could deduct all of
the intangibles. Also included was an example from which it
could be concluded that the same result would follow under
an Abercrombie type of interest. Such a result would have
been consistent with the withdrawal by the Service of its prior
acquiescence in Abercrombie and the Fifth Circuit’s repudiation
of Abercrombie in the Weinert case. Yet, no sooner
had the situation been crystallized after twenty-three years
of doubt than the IRS restored the prior chaotic conditions by
withdrawing its proposed provisions. The regulations finally
adopted were substantially identical to the 1939 regulations
in their silence as to allocation of the intangibles deduction.
The adoption of the final regulations was accompanied by an
announcement indicating a willingness to entertain requests
for rulings in appropriate cases and stating that “[i]n such
rulings, the decision of the Service will depend on the particu-
lar facts and circumstances of each individual case.”

Of the carried interest arrangements in the funds exa-
mined, three appear to be of the Manahan type, whereas one
could be classified as an Abercrombie carry. If the IRS and
the courts were to apply the Abercrombie rationale, the invest-
ors in all these funds would lose part of the deduction for
intangibles. Despite the withdrawal of the proposed regula-
tions, however, it is believed that the IRS has no desire to
revive Abercrombie. Nevertheless, in view of the expressed
willingness of the Service to grant rulings in this context, it
would appear advisable for interested parties to obtain one.

The net operating profit arrangements employed by two
of the funds as well as the retained override arrangement
should permit their investors to take the deduction for intangi-
bles. On the other hand, the net profit arrangement has an

112. See note 102 supra.
114. Weinert v. Commissioner, 294 F.2d 750 (5th Cir. 1961). See text accom-
panying note 106 supra.
117. See K. Miller, supra note 102, at 212 n.23.
118. See Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Kirby
Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); G.C.M. 22,730, 1941-1
adverse impact on the sponsor, since it will have to compute statutory depletion on net income from production rather than a percentage of gross income.\textsuperscript{119} In the view taken by the IRS, the net amount received by the holder of a net profit interest represents his gross income from production.

While net profit and override agreements permit investors to take the depreciation deduction on tangible equipment,\textsuperscript{120} carried interest arrangements which vest a portion of the ownership of such equipment in the sponsors after payout will to that extent preclude a depreciation deduction. The investors are unable to take advantage of the deduction because they no longer own an interest in the equipment, and the deduction will not be available to the sponsor because it has no basis in such equipment. Conceivably this result could be avoided by the investors’ retaining title to all of the equipment even after payout, but there is a risk that such a retained interest might be classified as a net profit interest.

The principal disadvantage of the arrangement employed by the seven funds examined is the likelihood that the sponsor will be taxed to the extent of the value of the interest it received. An analysis of this problem requires an understanding of the sharing arrangement or pool-of-capital doctrine established in connection with mineral operations in 1925.\textsuperscript{121} It has been clear since that time that if one owns mineral rights and agrees to transfer an interest in those rights in return for an agreement to drill a well, the transaction is non-taxable as to both parties. According to the underlying rationale the owner of the mineral property has not sold an interest in the property, but rather has pooled his resources with the party who obligates himself to drill the well.

The same rationale was extended by G.C.M. 22,730\textsuperscript{122} to situations in which an owner exchanges an interest in his

\textsuperscript{119} Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Grandview Mines v. Commissioner, 282 F.2d 700 (9th Cir. 1960).

\textsuperscript{120} The availability of the depreciation deduction is based upon the fact that the investors will be the sole owners of the working interest and will have a basis in the equipment. Care must be taken in drafting the net profit interest to provide that the owner thereof acquires no interest in the equipment. As to the carried interest, the IRS apparently requires the carrier at payout to reduce its undepreciated tangible equipment account and to increase its leasehold account by a corresponding amount. See K. Miller, supra note 102, at 214.

\textsuperscript{121} S.M. 3322, IV-1 CUM. BULL. 112 (1925).

\textsuperscript{122} 1941-1 CUM. BULL. 214. See also Treas. Reg. § 1.612-4(a) (1965).
mineral property for supplies and equipment used in the drilling of a well, for the services of a drilling contractor, or for money pledged to the development of the property. It has been widely assumed that under this reasoning, geological, engineering, or legal services could be exchanged for an interest in mineral property, provided such services related to the acquisition, exploration, or development of the property, and that the transaction would otherwise be non-taxable. However, the IRS now takes the position that the sharing agreement rationale is not applicable to the contribution of personal services. While it may be difficult to justify distinguishing such services from those rendered by a drilling contractor, recent Fifth Circuit decisions tend to support the IRS position. In James A. Lewis Engineering, Incorporated v. Commissioner, that court, although not explicitly invalidating the sharing-agreement theory as applied to personal services, held that the services of a petroleum engineer in planning a secondary recovery program were not rendered in connection with "the acquisition, exploration or development" of the mineral property. However, in dicta the court did state:

Unless a careful analysis of the reasons underlying the issuing of G.C.M. 22,730 compelled it, the Court would have great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as a part of gross income.

Further, in United States v. Frazell, the parties apparently contemplated a sharing arrangement involving services. However, the court concluded that the property interest received for services was taxable as income. The court viewed the issue as a problem of partnership taxation and did not refer to either the sharing arrangement rationale or G.C.M. 22,730. The facts in Frazell were very similar to those involved in a typical exploration fund, though on a smaller scale. A geologist worked out an arrangement with two investors under

123. For an excellent discussion see generally Shelton, The Taxation of Oil and Gas Interests Received in Payment for Property or Services, 5 OIL & GAS INST. 385 (1954).
124. See K. Miller, supra note 102, at 21-23.
125. 339 F.2d 706 (5th Cir. 1964).
126. Id. at 709.
which he was to provide advice in the acquisition and exploration of mineral properties financed by them in return for a carried interest which "vested" in the Manahan sense after the investors recovered their investment. The parties, with their apparent acquiescence, were assumed to have formed a partnership. On this basis, the court held that the geologist realized income to the extent of the value of the interest received in the year of vesting. The court then proceeded to determine the value of the interest at the time of payout. While Frazell is complicated by the fact that the parties formed a corporation prior to payout, it is clear that payout ordinarily would be regarded as the time of vesting. It would appear from the court's approach, however, that, depending upon whether a Manahan or Abercrombie type carried interest is reserved, there may be a difference in the year in which the income is received. Whereas in the case of a Manahan carry the appropriate year would be the year of payout, an Abercrombie carry would produce a tax in the year in which the interest was created. If production from the property is insufficient to return initial costs such as that for drilling, a Manahan carried interest will be advantageous, since the interest of the sponsor will never vest. Conversely, if oil is found in commercial quantities an Abercrombie interest is preferable, since the interest of the sponsor presumably has less value prior to drilling than it will have after payout.

A sponsor retaining a carried interest in property it contributed to the exploration fund could probably avail itself of the sharing arrangement rationale. The fund must, however, possess such property prior to raising money from the public. If the funds examined above provide a reliable guide, however, this is not the usual procedure. While in many instances the sponsor does acquire properties, which it then transfers to the fund with a retained carried interest, these properties are usually acquired with fund monies. Thus, it is apparent that the sponsor is receiving its interest in exchange for the management services provided and not because it contributed the properties. In fact, most of the prospectuses examined specified that the sponsor received its interest in return for its know-how and professional efforts. Apparently, the sponsor is either accepting taxable income to the extent of the value of the interest or anticipating the applica-
tion of G.C.M. 22,730 to personal services. Even if one could disregard Lewis and Frazell in this context, G.C.M. 22,730 has always required that the interest be acquired in properties with respect to which the services were rendered. Since some services—arranging and managing the overall financial program and screening properties which are not acquired—often are unrelated to any particular property, it is arguable that, in part at least, the sponsor's interest in a particular property is received for unrelated services.

The three funds which employed a limited partnership attempted to give the sponsor its interest outside of the partnership. This fact suggests that counsel may have sought to avoid the impact of Frazell, which was decided in the context of the partnership provisions of the Code. This attempted evasion may be a futile gesture, however. A carried interest arrangement will probably always result in taxable income to the sponsor unless a convincing rebuttal is proposed to the Fifth Circuit's premise in the Lewis case that property received as compensation for services yields taxable income. The Frazell decision is best explained by the fact that the taxpayer in that case planned a sharing arrangement, but was trapped under a partnership rationale which should not have been applicable to the particular facts. It would appear that the key to the Frazell decision is the court's statement—apparently correct on the particular facts—that the amounts recovered by the other partners represented a "skimming of profits" rather than a return of capital; therefore, the service-partner received an interest in the other partners' capital accounts. Appropriate drafting of the partnership agreement could avoid the Frazell result by limiting the service-partner to a share of the profits plus his own capital account and precluding any portion of the other partners' capital accounts from vesting in the service partner. There are, of course, alternative methods of accomplishing this result, each of which has varying economic and tax consequences. Such arrangements include the following:

128. 339 F.2d at 888. The court's conclusion came in response to the argument that Treas. Reg. § 1.721-1(b)(1) 1956, while providing exempt status for repayment of contributions to a partner, does not extend to the relinquishment by a partner of his right to repayment in favor of another partner as compensation for the latter's services.
The sponsor-partner and the investor-partners immediately share in the profits, but the latter recover their investment as a return of capital from the first available funds. Assuming that all of the deductions have been allocated to the investor-partners and that their respective capital accounts are reduced to the extent of the deductions, this approach will ensure a “payout period” considerably shorter than that incurred under the typical carried arrangement. While the investor-partners are allocated all of the deductions, the sponsor-partner will pay tax on its share of partnership income during the abbreviated payout period even though it is not receiving any distributions. Thus, the economic impact is that the investor-partners recover as a return of capital a portion of their investment and the sponsor-partner builds up a corresponding amount of capital but at a tax cost to it.

The sponsor-partner immediately shares in partnership profits and distributions. Under this arrangement, the sponsor-partner will be paying tax on his share of the income and will have offsetting distributions from the partnership. The economic effect is that the sponsor-partner’s capital account will not catch up with that of the investor-partners, since the latter’s “preference”—original investment reduced by the deductions allocated to it—will be delayed until dissolution.

All of the partnership income and deductions are allocated to the investor-partners until their original investment has been returned in the form of partnership profits. During payout the investor-partners will be taxed on all of the partnership income and the sponsor-partner will incur no tax. Thus, during payout the sponsor-partner is neither receiving income nor building up a capital account. The investor-partners, on the other hand, recover all of their investment and, in addition, have a “preference” on dissolution to the extent of their original capital contributions less the deductions allocated to them during payout. This approach appears to be most in accord with the general objectives being sought by most exploration funds. Whichever method is chosen, however, the partnership arrangements
will have the additional advantage of permitting all of the depreciation deduction to be utilized.\textsuperscript{129}

It is essential to note that the court in the \textit{Frazell} case seemed at times to be equating the capital contribution of partners with the assets acquired with such contributions. If such equation gains further judicial acceptance, the foregoing analysis of \textit{Frazell} is not correct.

The above planning techniques are, of course, oversimplified, for attention must also be given allocation of depletion reserves and capital gains and losses.\textsuperscript{130} However, with careful planning it should be possible to accomplish the general objectives sought and at the same time avoid giving the sponsor-partner an interest in the investor-partners' capital accounts. When this result is achieved, section 1.721-1(b)(1) of the regulations should be applicable. This section was not applicable in \textit{Frazell} because, after the investor-partners recovered their investment from a skimming of profits, the service-partner received an interest in the whole ball of wax, which necessarily included part of the investor-partners' capital accounts.

As a general rule the allocation of income and losses among partners will be sustained if such allocation has econo-

\textsuperscript{129} Since the partnership would own all of the equipment and thus have a basis, it would take the depreciation deduction. INT. REV. CODE OF 1954, §§ 702-03. For discussion of a comparable problem if a carried interest arrangement is utilized see text accompanying note 120 supra.

\textsuperscript{130} The assistance of a knowledgeable accountant may be helpful in avoiding an inadvertent distribution of any part of the investor-partner's capital accounts to the service-partner. An additional problem arises from the fact that the regulations do not refer to the accounting concept of capital accounts, but rather to the right of a partner under partnership law to be repaid his capital contribution. Treas. Reg. § 1.721-1(b)(1) (1956) is based upon the principle of partnership law that each partner is normally entitled to be repaid his contribution of money or other property. Thus, the service-partner realizes income when this right—as distinguished from a sharing of the profits—is invaded. The easiest method of avoiding such invasion and of complying with the regulation would be to treat contributions as loans and to provide for repayment of them, a plan which would have the same effect as illustration (2) in the text and involve a tax cost to the service-partner. Alternatively, such amounts could be treated as a "preference" on dissolution and, thus, be left unaffected by allocation of deductions to the investor-partners. However, it would be highly questionable whether such allocations have economic effect. If they do not, they will be disallowed. See note 132 infra. Assume that during a period of time the investor-partners are entitled to all of the profits and take all of the losses and deductions, thereby reducing their capital account to the extent losses and deductions exceed profits. This arrangement would appear to be consistent with the regulations, since partnership law provides that each partner shall be repaid his contributions and share in profit and losses with partners' contributions being preferred upon dissolution. \textit{Uniform Partnership Act} §§ 18(a), 40.
mic effect. The allocations outlined above clearly would qualify, since in each instance they affect the partners' capital accounts and, thus, the amounts ultimately received. While deductions might be allocated to the investor-partners without reducing their capital accounts by a corresponding amount, varying economic results would still be achieved in each of the above examples.

It should be noted that to the extent deductions result in losses allocable to the investor-partners, these partners cannot take such losses in excess of their basis in the partnership. The tax opinions reflected in the prospectuses of the funds examined fail to note this limitation. Since many of the deductions are taken directly by the partner—intangibles in the case of oil and gas, exploration expenditures in the case of other minerals—it may be questioned whether these are subject to the same limitations. The Code does not literally impose an equivalent restriction on direct deductions, although capital losses, which are also claimed individually by the partners, are specifically limited to the individual's partnership basis. Nonetheless, it is probably advisable to assume that such deductions are subject to a similar limitation, particularly in view of the fact that the Code requires the partner's basis to be reduced by an amount corresponding to the deduction, but explicitly disallows any reduction below zero.

If a Subchapter S corporation were utilized to form an exploration fund and the sponsor were a shareholder, his receipt of stock in return for services would not only result

131. Treas. Reg. §§ 1.704-1(a), (b) (1956). Other factors considered by the Treasury are: (1) Whether there was a business purpose for the allocation, (2) whether related items from the same source are so allocated, (3) the duration of the allocation, (4) the overall tax consequences of the allocation, (5) whether normal business factors were recognized, and (6) whether the amount of the allocation was at the time subject to reasonable estimation.

132. Economic effect could be ensured, for example, by treating deductible items for accounting—as distinguished from tax—purposes as capital expenditures. If the allocated deductions do not reduce the capital accounts of the investor-partners, the economic effect is to increase the "preference" of such partners on dissolution. From the viewpoint of the account, however, the deduction would have only tax consequences and hence might be vulnerable. Id. § 1.704-1(b) (2).

133. INT. REV. CODE OF 1954, § 704 (d). Losses in excess of the basis of the partner's interest, however, may be carried forward and utilized in the first subsequent year in which the partner has a basis exceeding zero. Treas. Reg. § 1.704-1(d) (1) (1966).

134. INT. REV. CODE OF 1954, § 705 (a) (2) (B).

in taxable income, but might also yield liability for stock watering\textsuperscript{136} or for issuing stock for future services.\textsuperscript{137} Conceivably the latter problems could be avoided if no-par or low par value stock were issued and the sponsor paid nominal cash amounts at least equal to par. Presumably, however, the IRS would look at the substance of the transaction and conclude that the stock was issued for future services. A preferable alternative would be to form a limited partnership consisting of the sponsor as a general partner and the investors, organized into a separate Subchapter S corporation, as the limited partner. Under this arrangement not only would the corporate status of the sponsor not affect the Subchapter S election of the investors, but also, by limiting the sponsor to an interest in partnership profits and its own capital account as outlined above, the receipt of such interest should not constitute taxable income. It might be argued in this context that all of the income of the Subchapter S corporation is of the disqualifying, passive type;\textsuperscript{138} but this conclusion would necessitate disregarding the existence of the partnership\textsuperscript{139} and thereby stretch the substance-over-form argument to the limit.\textsuperscript{140} If the sponsor is to be the general partner, it may be important for it to have substantial assets in addition to its interest in the partnership, since an inability to show financial independence may support the conclusion that the entity has achieved limited liability and is, therefore, an association taxable as a corporation.\textsuperscript{141}

**The Investment Company Act**

While, as previously noted, exploration funds share common characteristics with mutual funds and some in fact

\textsuperscript{136} See H. Henn, Corporations 247-57 (1961).
\textsuperscript{137} Id. at 247.
\textsuperscript{138} Int. Rev. Code of 1954, § 1372(e)(5) provides that the election under Subchapter S shall terminate for any taxable year in which the corporation has more than $3,000 in passive investment income, and such income exceeds 20% of its gross receipts. Passive investment income is defined as that realized from royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock or securities.
\textsuperscript{139} If the partnership itself were classified as an association, see text accompanying notes 77-80 supra, amounts received by the Subchapter S corporation from the partnership would be dividends and, thus, clearly passive income.
\textsuperscript{140} Leasehold interests held by the fund may be classified as investment contracts and hence securities. See text accompanying note 145 infra.
\textsuperscript{141} See note 78 supra.
attempt to give the appearance of being a counterpart of a mutual fund, they are, nevertheless, not investment companies as that term is defined by the Investment Company Act of 1940. Yet, only one of the seven prospectuses examined specifically stated that the fund was not an investment company.

Any doubt concerning the status of exploration funds under the Investment Company Act is eliminated by section 3(c)(11), which specifically excludes from the definition of an investment company any corporation substantially all of whose business involves holding oil, gas, or other mineral royalties or leases. The Commission, however, has proposed an amendment to section 3(c)(11) which would confine this exclusion to such companies only if they are "not engaged in the business of issuing redeemable securities, face-amount certificates of the installation type or periodic plan certificates . . . ." Significantly, two of the seven exploration funds examined issued redeemable securities and what appear to be periodic plan certificates. Moreover, since all of the remaining funds either provide for commitments payable as called or at specified intervals, it is conceivable that some of these funds might be deemed to have issued periodic plan certificates. Such issues, however, do not appear to be an essential ingredient to an exploration fund operation and could be readily modified in order to avoid classification as an investment company under the Act. Those funds not within the exclusion must be engaged "in the business of investing, reinvesting, or trading in securities" to be classified as an investment company under the Commission's proposed amendment to section 3(c)(11). Thus, it becomes necessary to determine whether such funds are investing in securities. To the extent they acquire fractional undivided interests in oil and gas leases, as distinguished from entire leases, they are

143. Id. § 80a-3(c)(11).
144. The Commission's proposal to amend § 3(c)(11) is incorporated in S. 1659, 90th Cong., 1st Sess. § 3(b) (5) (1967).
145. Id. Section 3(a) of the Investment Company Act defines an investment company as an issuer which "holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities . . . ." 15 U.S.C. § 80a-3(1) (1984). Section 3(c)(11) presently excludes from this definition "[a]ny person substantially all of whose business consists of owning or holding oil, gas, or other mineral royalties or leases, . . . ." including fractional interests and/or investment contracts. Id. § 80a-3(c)(11).
clearly so doing. Securities trading could be found in connection with farm-outs and also, perhaps, in those instances where the sponsor-manager retains or otherwise receives a carried interest.\(^{146}\)

If, however, the fund acquired only entire leaseholds, it would be necessary to classify such interests as investment contracts in order to regard them as securities. The SEC might take the position that regardless of the form of the exploration fund, such an arrangement should be viewed as constituting an "entity," even though not a conventional one. The Commission could then argue that, while in form the fund purports to invest in oil and gas properties and to conduct an oil and gas exploration business, the fund itself is only nominally acquiring properties and has no real control over the development of the properties. Rather, the argument would continue, the fund actually acquired a series of investment contracts, each of which consists of an oil and gas lease with a management contract (operating agreement), under which the manager will cause wells to be drilled. To buttress this position, reliance would be placed on \textit{SEC v. C. M. Joiner Leasing Corporation,}\(^{147}\) which involved the sale of oil and gas leases with a representation relating to the drilling of a well, and \textit{SEC v. W. J. Howey Company,}\(^{148}\) which considered the sale of specifically described citrus groves with a management contract. Viewed in the context of these precedents, the business of the fund consists of dealing in investment contracts, which are securities, rather than actually operating mineral properties. Such a conclusion requires a two-step analysis: (1) The investor in an exploration fund acquires an investment contract or interest in a profit-sharing agreement, and (2) the fund in turn is engaged in the business of acquiring investment contracts relating to oil and gas development. The foregoing problem remains academic, however, unless and until section 3(c)(11) of the Investment Company Act is amended as proposed.

\(^{146}\) Section 2(a) (35) of the Investment Company Act defines a security to include "investment contracts" and "fractional undivided interest[s] in oil, gas or other mineral rights." 16 U.S.C. § 80a-2(a) (35) (1964). For a discussion of the possible classification of oil and gas interests as securities see generally H. BLOOMENTHAL, \textsc{Securities Law} 58-72 (1965).

\(^{147}\) 320 U.S. 344 (1943).

\(^{148}\) 328 U.S. 293 (1946).
If some exploration funds were legislatively classified as investment companies, significant changes would be required in the format and practices of such funds. Registration under the Investment Company Act\textsuperscript{149} would, of course, be necessary, and the funds would be subject to the more stringent reporting requirements of that Act.\textsuperscript{150} In addition, a whole panoply of regulations would come into play, the most important being the requirement that all transactions, property transfers, etc. between affiliates and the funds would have to be submitted to the Commission for a determination, after notice and hearing, that the terms were reasonable and fair.\textsuperscript{151} Moreover, if pending legislation relating to investment companies were adopted, sales charges would be regulated and management fees and compensation would be scrutinized.\textsuperscript{152} It is probable, however, that the exploration funds affected would discontinue the issuance of redeemable securities or periodic plan certificates, in which event they would remain within the section 3(c)(11) exclusion even if it were amended as proposed.

**Securities Act—What Is the Security?**

When a limited partnership is utilized to form an exploration fund, the limited partnership interest is a security.\textsuperscript{153} In many instances, however, the limited partnership is not in being at the time of the offering, and hence merely pre-organization subscriptions in a limited partnership are offered.\textsuperscript{154} Where co-ownership interests are offered, it is


\textsuperscript{150} In addition to filing with the Commission prescribed annual and periodic reports and statements of share ownership, a registered investment company must transmit semi-annual reports to its shareholders. Investment Company Act § 30, 15 U.S.C. § 80a-29 (1964); 17 C.F.R. §§ 270.30a-1 to .30f-1 (1967).


\textsuperscript{152} See S. 1659, 90th Cong., 1st Sess. §§ 8(d), 12(c) (1) (1967).

\textsuperscript{153} Section 2(1) of the Securities Act defines a security to include a “certificate of interest . . . in any profit-sharing agreement . . .” 15 U.S.C. § 77b(1) (1964). Some commentators would find no security if there were only a few limited partners and no substitution of partners without consent of the others. See L. Loss, Securities Regulation 504-05 (1961). For a discussion of partnership interests as securities see generally H. Bloomenthal, supra note 146, at 78-81.

\textsuperscript{154} "Pre-organization subscriptions" are within the Securities Act definition of a security. Securities Act § 2(1), 15 U.S.C. § 77b(1) (1964). It does not appear to be feasible to organize the partnership in advance of an offering, since § 2 of the Uniform Limited Partnership Act requires the filing of a certificate which includes the names and the capital contributions of each of the limited general partners and since § 8 requires the filing of an amendment to the certificate before additional limited partners may be admitted. Two of the funds examined included provisions in the pre-organization subscriptions which gave a designated person a power of
conceivable that the security consists of the fractional undivided interests in mineral rights.\textsuperscript{155} Nevertheless, since no specific mineral rights exist at the time of the offering, it is more likely that what is offered would be viewed as an investment contract—the investment of money with the expectation of a return as a result of the efforts of the sponsor\textsuperscript{156}—or as a profit-sharing agreement.

A related problem is isolating the consideration exchanged for the security. The issue is most apparent with respect to the sale of fractional undivided interests in oil and gas rights. The decisions in this area have varied significantly, with one state court concluding that only the consideration given for the fractional undivided interest, as distinguished from the cost of drilling the well, was the consideration for the security,\textsuperscript{157} and a federal tribunal holding that the amounts paid for drilling the initial well, the completion costs, and the cost of drilling additional wells were all part of the consideration.\textsuperscript{158} Although the former holding is not likely to be followed since it overlooks the investment contract concept, it does not necessarily follow that completion costs and the cost of drilling additional wells will be regarded as part of the "purchase price." A comparable problem of isolating consideration exists with regard to exploratory funds, since, as noted, the original investment often does not cover completion costs or the cost of drilling additional wells. The resolution of the consideration issue is important, because purchase price determines, among other things, the dollar amount of securities to be registered and the measure of recovery in a civil action for damages or rescission arising out of the sale of such securities. While it is impossible to make a definite determination from the

\textsuperscript{155} Fractional undivided interests in mineral rights are specifically within the statutory definition of a security. Securities Act § 2(1), 15 U.S.C. § 77b(1) (1964).

\textsuperscript{156} See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1948).

\textsuperscript{157} Hammer v. Sanders, 8 Ill. 2d 414, 134 N.E.2d 509, cert. denied, 352 U.S. 878 (1956).

prospectuses examined, they appear to have assumed, with the apparent acquiescence of the SEC staff, that only the specific payments provided for—and not "assessments"—constituted the consideration for the security. Interestingly, in the somewhat analogous situation of assessable securities, the Commission takes the position that each assessment involves a sale and that the additional charges constitute part of the purchase price of the security.¹⁵⁹

Assuming that all monies payable under a particular fund arrangement, including completion costs and cost of drilling development wells, are part of the sale price, an important question is whether there is a continuing offer of the security until these monies are called for and paid. If a continuing offer is found, the fund must, among other things, revise its prospectus and furnish the participants with the revision. Since in most of the arrangements examined the investor is committed from the time of his initial participation to pay his proportionate share of the completion costs, it would appear that no new investment decision is involved—unless a decision to breach one's contractual obligation can be viewed as an investment decision. Thus, there would presumably be no continuing offer. However, there is generally no obligation to contribute monies to drill additional development wells, although failure to contribute may result in either forfeiture of a portion of the acreage or other penalties. Nevertheless, in another context, the existence of a continuing offer has been held to depend upon whether the investor is making a new investment decision.¹⁶⁰ Of course, if the SEC concludes that additional contributions to an exploration fund are not part of the sale price of the security, the issue of whether there was a continuing offer would not be reached. In those funds in which investors have the right to elect not to participate in particular projects, the possibility of an enduring offer is again raised. Because there is still an element of volition involved, it might be argued that a currently valid prospectus must be delivered at the time of the election. Moreover, one of the funds provided for annual commitments which could, after the end of the year, be avoided by the

investor if he had participated in the program for three calendar quarters. This structure raises the distinct possibility that any offer made after the investor could elect to terminate is a continuing or new one.

The prospectuses of the funds examined seemed to assume, with apparent SEC approval, that there was no continuing offer problem in the situations described above. The SEC's acquiescence in this assumption may reflect a pragmatic approach, since the funds might be tempted to eliminate whatever volition investors do have and bind them to extensive future commitments. Yet, SEC disapproval of the assumption would promote more informed investor decisions, for the funds would be compelled to furnish all details relating to specific properties, a disclosure they currently can avoid by assuming that there is no continuing offer. While some of the funds giving investors an election to participate in particular projects purported to furnish appropriate information upon which a decision could be based, the content of these disclosures is not scrutinized by the SEC staff for accuracy or adequacy as would be the case if a revised prospectus were required.

Since exploration funds are relatively new on the securities scene, there do not appear to be any decisions that involve the precise questions raised above. Accordingly, it may be advisable to obtain SEC staff rulings when such issues arise.

SECURITIES ACT—WHO IS THE ISSUER?

Identifying the issuer of securities offered by exploration funds is important for a number of purposes under the Securities Act of 1933. For example, an issuer must file and sign the registration statement and is subject to the liabilities imposed by section 11 of the Act for false or misleading statements in the registration statement. Further, resolution of the question determines in part the content of the registration statement.

162. Section 11 presents a comprehensive scheme of liability directed against the "issuer" and other designated persons. The issuer, however, cannot avail itself of any of the enumerated defenses which are available to other defendants. Securities Act § 11, 15 U.S.C. § 77k (1964).
statement.\(^{163}\) With respect to a limited partnership existing at the time of the offering, it would appear that the partnership is the issuer.\(^{164}\) However, in view of the often nominal nature of these partnerships, it would not be unreasonable to treat the sponsor as the issuer, at least for disclosure purposes.\(^{165}\) In the other arrangements commonly used for exploration funds, the sponsor is and has been regarded as the issuer, although it is possible that the fund itself could be viewed as an entity and as such the "issuer."\(^{166}\) While the foregoing discussion has assumed throughout that the sponsor is a single entity, in most of the funds examined the sponsor consisted of more than one entity. Frequently a subsidiary or affiliate of a large company had been organized for the specific purposes of offering the interests involved and acting as issuer, while the larger company acted as manager and derived the management compensation. The subsidiary or affiliate company was frequently newly organized, with neither a significant prior operating history nor very substantial assets. Thus, the financial statements required of the issuer were easily prepared and not very revealing. Among the funds studied, one issuer had total assets of $87,000, although its parent, for which financial statements were not included, was a more substantial company; three reported assets of $10,000, $12,500, and $1,000 respectively, with no disclosure regarding their parents; and finally, two issuers had assets of $250,000 cash, but apparently at one time followed the practice of lending all their cash back to their parent. The partnership fund examined included no financial statements, apparently

163. Schedule A to the Securities Act, which enumerates information to be included in the prospectus and registration statement and the additional data called for by the appropriate form (S-1 through S-14), pertains, for the most part, to the "issuer." 15 U.S.C. § 77aa (1964).

164. Section 2(4) of the Securities Act defines the term "issuer" to mean every person—a term which includes a partnership under § 2(2)—who issues or proposes to issue any security. 15 U.S.C. § 77b(4) (1964).

165. The Commission has broad authority under § 7 of the Securities Act to require by rules and regulations that the registration statement include such other information as the Commission may consider necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 77g (1964).

166. The Securities Act definition of "issuer," see note 164 supra, is adequate for securities issued by a conventional entity such as a corporation or partnership. However, some of the unique arrangements employed by exploration funds, not involving any formal-type entity which issues a security granting the holder rights in the organization, poses some conceptual problems not anticipated by the Act. While it may be convenient for Securities Act purposes to regard the sponsor as the "issuer" since it "issues" the security, such a construction would completely frustrate the registration objectives of the Exchange Act, see text accompanying notes 175-87 infra, with respect to such securities.
treated the partnership, which had but $100 in assets, as the issuer. It is also interesting to note that, to the extent financial statements were included, only a balance sheet was required.\textsuperscript{167}

The use of a specially created affiliate as an "issuer" probably does not affect the parent's liability under section 11 in view of the provisions of section 15 imposing comparable liability on persons controlling the issuer.\textsuperscript{168} However, such use does affect the nature of the disclosures, for prospective investors are deprived of relevant financial information concerning the actual sponsor.

\textbf{Registration and Reporting}

The necessity for registration under the Securities Act will ordinarily depend upon the availability of an exemption, particularly the one for private offerings.\textsuperscript{169} For the private offering exemption to be available, the offer must be made to a predetermined group of investors having available information comparable to that which would be included in a registration statement.\textsuperscript{170} If, as is usually the case, such an offering is made to persons other than institutional investors, a serious question frequently arises as to whether such investors are sufficiently "sophisticated" and have adequate information available to them to satisfy the foregoing criteria. The fact that the investors are high-bracket taxpayers does not per se establish such sophistication,\textsuperscript{171} although investors in this category who employ their own geologists and other experts to assist them in their investment program would conceivably meet the necessary qualifications. Yet, in view of the fact that a single offer to a non-sophisticated investor will destroy

\textsuperscript{167} The financial disclosure required of an exploration fund parallels the practice followed with respect to mutual fund proxy solicitations, for there the balance sheet of the management company, though not an "issuer" for the purpose of such solicitation, must be included. 17 C.F.R. 270.20a-2(a) (9) (1967). Apparently, requiring only a balance sheet represents a compromise which recognizes that some financial information is desirable, but which allows something less than the usually required disclosure.


\textsuperscript{169} Securities Act § 4(1), 15 U.S.C. § 77d(2) (1964). An issuer confining its offering exclusively to bona fide residents of the state in which it is incorporated and doing business—or resides, if not a corporation—may be able to utilize the intrastate exemption provided by § 3(a)(11) of the Securities Act, 15 U.S.C. § 77c(a)(11) (1964).


the exemption as to all the investors, it may be advisable to register the securities, even though the actual participants are few in number.

If an exploration fund having 300 or more participants is registered under the Securities Act, it will be subject to the periodic (Form 8-K) and annual (Form 10-K) reporting requirements. Even if a fund has less than 300 participants, it must file such reports for the fiscal year in which its registration statement becomes effective. Since Form 8-K, a monthly report filed for the month in which any of the events specified in the form occur, calls for information relating to the acquisition of a significant amount of assets otherwise than in the ordinary course of business, it could be an important source of information concerning properties actually acquired by a fund. However, there will always be the question of what constitutes "ordinary course of business" for this purpose. Further, only limited information need be furnished, including a brief description of the asset, the consideration paid for it and the persons from whom it was acquired. While for registrants with less than 300 participants such reports are required only during a limited period of time, in many instances this would be a critical period since most exploratory funds have one-year programs. The most glaring shortcoming of the present reporting system, however, is the fact that, although these reports are filed with the SEC and subject to routine scrutiny by the staff, the reports are not disseminated to the participants nor made available to them unless the participants themselves take the initiative in examining the reports or obtaining copies of them from the Commission.

An exploration fund may also be subject to the registration requirements of the Exchange Act, which is applicable to any class of equity securities held of record by 500 or more security holders, if the issuer has total assets exceeding $1,000,000. Rules adopted by the Commission specifically define a limited partnership interest as an equity security for the purpose of registration, and these rules are probably

172. See id.
175. Id. § 12(g) (1), 15 U.S.C. § 78l(g) (1) (1964).
broad enough to encompass the securities issued by other types of exploration funds.\(^\text{176}\) Although the Exchange Act definition of "issuer"\(^\text{177}\) is substantially identical to the Securities Act definition,\(^\text{178}\) it seems imperative, if the registration provisions of the Exchange Act are to be given effect in this context, to regard the fund "entity," whatever it may be, as the issuer for the purpose of determining whether the $1,000,000 asset requirement has been met.\(^\text{179}\) Although the sponsor may be regarded as the issuer for Securities Act purposes, the sponsor's financial status seems a less appropriate subject of continued disclosure than that of the fund itself.\(^\text{180}\)

Where securities have already been registered under the Securities Act, Exchange Act registration can be accomplished with relative ease and will not add appreciably to the quality of information available.\(^\text{181}\) It is conceivable, but unlikely, that Exchange Act registration might be compelled of exploration funds not registered under the Securities Act, since some funds may have offered securities in violation of the registration provisions of the Securities Act or pursuant to the intrastate offering exemption.\(^\text{182}\) In any event, Exchange Act registration will necessitate the filing of current and annual reports with the Commission, a requirement to which a fund will already be subject if it has registered an offer under the Securities Act.\(^\text{183}\) In addition, registration under the Exchange Act will bring into play the short-swing profit provisions of that Act,\(^\text{184}\) although the opportunities for

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178. See note 164 supra.
179. See note 168 supra.
180. As noted previously, the sponsor which offers interests in exploration funds is often deliberately created with token assets and is typically affiliated with and under the control of a larger company. See text accompanying notes 166-68 supra. Such sponsor-offerers generally have only a few shareholders although the "fund" itself may have a large number of participants.
182. It is not likely that a fund would have 500 participants and yet not be subject to registration under the Securities Act. However, if the original participants divided their interests to the extent that there are now more than 500 holders, previous registration may have been avoided. In such event, or if the securities were originally offered in violation of the 1933 Act registration provisions, a fund may be caught within the Exchange Act registration requirement.
"insiders" to trade in the type of security involved ordinarily are very limited. Perhaps the most significant impact of Exchange Act registration would be the application of the proxy rules to the infrequent situations in which exploration funds are required to obtain authorizations or consents from their participants. Funds that give their investors a right to elect whether to participate in particular projects would presumably be subject to the proxy solicitation rules. It is also conceivable that requests to participate in the drilling of development wells would be viewed as a solicitation of consent. In both of these instances the proxy rules could fill an existing gap by compelling the disclosure of relevant information.

**Some Disclosure Problems**

As one would expect, all of the prospectuses examined referred to the speculative nature of the offerings. The following is a typical statement: "Exploration for oil and gas is highly speculative and its results cannot be forecast. Therefore, investors should not consider making any investments of funds other than portions of investors' income which is recurring and is normally subject to Federal Income Tax at high rates." Another prospectus suggested that it would be inappropriate to invest one's capital—as distinguished from recurring income—in the drilling of exploratory wells, but that it might be acceptable to invest capital in completion costs. While all of the funds appealed to the high-bracket taxpayer, one fund in its supplemental sales literature had an illustration designed to show that an investor need not be in an upper bracket to realize tax savings from oil and gas investments. Perhaps the most effective means of keeping out the small investor, however, are the high minimum financial commitments required of participants. Yet, one of the funds had a minimum commitment of only $1,500 and permitted a $1,300 subscription on a monthly participation plan of three monthly down payments of $150 and periodic payments of $50 for the balance. The fund purported, however,

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187. There was a paucity of information furnished with respect to the properties to be developed. See text accompanying note 189 infra.
to limit its activities to proven and semi-proven properties, which should make its operation somewhat less speculative. Significantly, a subsequent program, brought out by an affiliate of the sponsor of this fund, related to a wildcat program and required a minimum of $5,000 or a monthly participation plan of $6,600 with $3,000 down and 24 monthly payments of $150 each.

Disclosures concerning potential conflicts of interest were included in the prospectuses of the funds studied although with varying degrees of emphasis. Statements were typically made concerning the experience, or lack thereof, of management in carrying on oil and gas exploration activities, the interest of management in transactions undertaken or to be undertaken between it and the fund, and management’s compensation. Moreover, as previously noted, financial information in the form of a balance sheet relating to the sponsor was generally included. Since the funds studied had no specific mineral interests at the time of the offerings, the only disclosure relating to properties pertained to the general geographical areas in which the funds planned acquisitions and the classification of these properties in terms of wildcat, semi-proven, or proven properties. The manner in which proceeds were to be used was generally shown in terms of a percentage allocation rather than an estimate of the number of dollars to be spent. The breakdown in this regard is significant, since it determines the extent to which participants will be able to currently deduct their investment. Of the seven funds examined, two included no breakdown at all, one showed acquisition costs (capitalized and recoverable through depletion) of an unrealistic one percent, two showed acquisition costs of twenty percent and one of thirty percent. Expenditures on intangibles were estimated at sixty percent in two funds and seventy percent in two others. Two of the funds

188. Some of the funds examined appear to have made successful efforts to obtain prestigious persons as officers or directors of the sponsor, including in one instance a former counsel to the President of the United States.

189. The fact that the funds do not own mineral properties at the time of the offering greatly simplifies the disclosure problem and avoids the necessity of making disclosures, for example, that the company’s properties have “only a very remote possibility of obtaining profitable production.” Such a disclosure was made by a fund organized in 1962, which chose to include a specific property in its “portfolio” prior to offering securities to the public. It is a safe assumption that this disclosure was required by the staff, and was perhaps warranted by the particular property.

190. See text accompanying notes 99-141 supra.
did not break down expenditures between drilling costs, which are generally deductible, and completion costs, which are generally capitalized and recovered through depreciation, but showed the combined costs of fifty-five percent in one instance and ninety percent in the other. One fund had yet another breakdown, estimating equipment costs of twenty-five percent and lumping deductible drilling costs with certain non-deductible costs exclusive of equipment in a forty-five percent estimate. Obviously, improvements could be made in such divulgements by requiring the typical SEC disclosure in terms of priority of the use of funds with separate estimates of the amount deductible for tax purposes, the amount to be capitalized and recovered through the depletion deduction, and the amount to be capitalized and recovered through the depreciation deduction.

Since all of the offerings studied were on a best-efforts basis, they utilized the usual disclosure that no assurance was given that any part of the proceeds would be realized and that, in the case of inadequate response to the offering, no part of the proceeds would be returned to investors. However, all of the funds provided that unless a specified minimum were committed by participants prior to a specified date, all monies would be returned without deductions. While the Commission has no power to require return of proceeds in case of insufficient response, it is reasonable to assume that the staff "encourages" this approach.

The type of information included relating to tax aspects of investments in exploration funds has been discussed previously. At least two of the funds also used a table designed to show, for a taxpayer in the highest bracket (seventy percent), the tax consequences both of proposed expenditures and of varying hypothetical net cash receipts realized from each dollar of such gross expenditures. Thus, one table assumed an expenditure of $100,000 for a participant and net cash receipts per dollar spent of none, fifty cents, one dollar, and a dollar and a half. On this basis the table showed a federal income tax credit of seventy percent of $100,000, or a net

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191. In some instances only very short periods of time were provided for return of investments. For example, one fund agreed to return all amounts received if it did not raise $500,000 within 35 days.

192. See text accompanying notes 54-55 supra.
out-of-pocket cost to the taxpayer of $30,000, which one can conclude would be the taxpayer's actual cost if no production were obtained. If production were obtained and income equivalent to fifty cents per dollar spent were realized, the taxpayer's net out-of-pocket cost would be $5,285. If one dollar were returned for every dollar spent, the table indicated a net return, after taxes and after giving effect to all deductions, of $19,425 in excess of $30,000 out-of-pocket costs to the taxpayer who invested $100,000, even though the enterprise merely returned the amount invested. If a dollar and a half in net cash were realized for every one dollar invested, the taxpayer would receive a net return of $44,140 in excess of his out-of-pocket costs.

While this table is carefully qualified, it requires a fair degree of tax sophistication to fully understand it. The net out-of-pocket cost on a $100,000 investment for a seventy percent bracket taxpayer is shown as $30,000 even if the well is productive. This would be true only if over a period of years—perhaps as many as twenty, depending upon the life of the oil deposit—all expenditures are deducted either as intangibles, depletion or depreciation. The table also assumed that the fifty percent of net income limitation under section 613 will not reduce statutory depletion as is possible, particularly in the year in which wells are drilled.\(^{193}\) Moreover, the table assumed, though without explicitly so stating, that a relatively small percentage of the initial investment would be spent for acquisition. If, for example, thirty percent of the initial funds went into acquisition costs, the excess for the most favorable return of a dollar and a half for every dollar expended would have been approximately $16,000 rather than the $44,000\(^{194}\) indicated in the table; and at a dollar return per

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193. See note 18 supra and accompanying text. Assuming intangibles are deducted, the effect is to reduce net income in the year a well is drilled, and, as to that particular property, possibly to reduce the amount of statutory depletion that could otherwise have been taken. For tax planning suggestions in this regard see generally Bloomenthal, A Guide to Federal Mineral Income Taxation (pt. 1), 1 Land & Water L. Rev. 77, 107-11 (1966).

194. | Figures Shown in Prospectus | Assuming 30% Spent on Acquisition Costs |
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<tr>
<td>1. Gross Expenditures</td>
<td>$100,000</td>
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<td>2. Tax Credits at 70%</td>
<td>70,000</td>
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<tr>
<td>3. Out-of-Pocket Costs</td>
<td>$30,000</td>
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<tr>
<td>4. Participant's Gross Income From Sale of Oil</td>
<td>$30,000</td>
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dollar spent, there would have been no excess, rather than the $19,425 shown. On the other hand, the most favorable return assumed in the table does not represent the upper limit of return in cases where oil is actually found.

The sponsor or an affiliate of the sponsor of five funds had organized exploration funds in the past, and the prospectuses of three of these funds included a record of the past performance of these prior programs. While two funds had no prior exploration fund experience, of the three funds reflecting previous experience, one ran back to 1952 and one had engaged in three and the other in two earlier programs. Rather detailed information was set forth in the prospectuses of these funds concerning the prior programs which they had conducted, including expenditures made, drilling results, pro-

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<th>Figures Shown in Prospectus</th>
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<td>1.</td>
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<td>Participant's Gross Income</td>
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<td>Cash Income Before Taxes</td>
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<td>7.</td>
<td>Statutory Depletion in Excess of Acquisition Costs</td>
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<td>8.</td>
<td>Taxable Income</td>
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<td>Federal Income Tax at 70%</td>
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<td>10.</td>
<td>Net Cash after Taxes</td>
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<td>11.</td>
<td>Less Out-of-Pocket Costs as Shown in 3</td>
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<td>12.</td>
<td>Excess (or Deficiency) of Available Cash Over Out-of Pocket Costs</td>
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duction history, and income derived from each of the operations. One fund pointed out that, because of prorationing, the amount of production shown did not reflect the maximum capacity of its wells.\textsuperscript{196} Three of the programs revealed by one fund showed, as of 1967, gross income in excess of gross expenditures. As to the other funds, none of the past programs had returned the monies invested in them. The sponsor with a fund history going back to 1952 had spent an aggregate of $107 million in all of its programs and had yielded gross income to participants of approximately $57 million. This fund published, though not as part of its prospectus, an estimate of reserves which suggested that its prior programs would overall return from approximately two dollars and a half to a dollar and seventy-five cents for every dollar invested, depending upon which reserves are used—those calculated by the company or those prepared by two independent petroleum engineers.\textsuperscript{197} In the subjective judgment of the author, of those examined this fund appears to be the best managed in terms of the personnel employed and the full-time nature of the efforts devoted to the fund. Reserve figures are apparently not available with respect to all prior programs of this fund. Moreover, the history of one earlier program is difficult to evaluate because it involved secondary recovery operations,\textsuperscript{198} and there do not appear to be any accepted engineering standards for evaluating or predicting the success of such undertakings.

\section*{Conflicts of Interest}

Potential conflicts of interest seem to abound with respect to exploration funds and, in fact, appear almost inevitable, since in most cases the sponsor devotes only part of its time to the exploration fund and independently engages in the oil and gas business. Conflicts, however, may exist not only

\begin{footnotesize}
\textsuperscript{196} To keep production in line with demand, several states impose restrictions on the amount of oil that may be produced from particular wells or fields. \textit{E.g.}, \textsc{Tex. Rev. Civ. Stat. Ann.} art. 6014 (1962). Often this regulation takes the form of, or has the effect of, limiting the number of days a producing well may be utilized during a month. Thus, one of the funds reported that the average monthly producing days allowed for its oil wells in Texas for 1965 had been 19.28 days compared with 8.88 days for 1965.

\textsuperscript{197} The fund estimated total net income of $267 million for its proved reserves, whereas two independent engineers employed by the fund for this purpose estimated $197 million and $186 million respectively as the total net income to be derived from proved reserves.

\textsuperscript{198} For a description of secondary recovery operations see note 4 \textit{supra}.
\end{footnotesize}
between the fund and the sponsor, but between the various funds organized by the same sponsor as well. The potentiality for conflict is particularly acute in the following situations: (1) determination of the price at which the sponsor sells properties or other services to the fund; (2) decisions concerning whether properties are to be acquired for the fund or the sponsor or an affiliate of the sponsor; (3) decisions by the sponsor concerning which properties he is to assign to the fund, thus permitting the assignment of the less desirable properties; (4) discovery of information in connection with the fund’s activities which would benefit the sponsor.

Some of these conflicts can be minimized, if not substantially precluded. For example, conflicts as to pricing of properties can be avoided by providing, as many of the funds do, for acquisition at cost. The possibility for other conflicts could also be eliminated by providing, as one fund to a large extent and some of the other funds to a lesser extent have done, that acquisitions for the fund are to be limited to areas different from those in which the sponsor will carry on its own exploration activities. Yet, even when this approach is adopted, conflicts could still exist between two funds managed by the same sponsor. One sponsor attempted to prevent this type of conflict by organizing one fund to engage in wildcat activities and limiting the other fund to the acquisition of proven or semi-proven properties. Another fund reduced opportunities for conflict by requiring the officers and employees of the sponsor to refrain from engaging in oil and gas activities and precluding acquisitions from persons affiliated with the sponsor.

199. One of the funds examined disclosed that an affiliate of the sponsor would sell the fund leases and other properties at “rates comparable to those paid by others in the oil and gas industry.” Yet, while oil and gas leases are widely sold, each lease to a degree is unique and market prices are seldom established. Another fund provided that an affiliate of a sponsor could sell the fund leases acquired by the affiliate prior to the organization of the fund for cost (including allocated overhead) plus 10%. However, this fund represented that no specific properties had been selected for resale. The same fund provided that properties acquired and transferred by the affiliate subsequent to the organization of the fund would be transferred at cost.

200. Another of the funds examined represented that, although an affiliate of the sponsor would continue to acquire properties for its own account as well as for the fund, all properties acquired would first be offered to the fund. Yet, because the affiliate and the fund were commonly controlled, the same people would be determining which properties were retained and which would be selected for the fund. In this particular fund, however, the sponsors were also substantial investors.
In two of the funds examined, the sponsor was a substantial investor in the fund, a factor tending to reduce any motivation to take advantage of the fund. Moreover, in all of the funds studied, the sponsor was dependent upon the success of the fund, if it were to realize substantial benefits for itself. However, in none of the funds were all potential conflicts eliminated, and disclosures relating to such conflicts were somewhat spotty.

With respect to those funds organized as limited partnerships, it would appear clear that the sponsor as general partner has fiduciary obligations to the limited partners.\(^{201}\) Similarly, it is very likely that fiduciary concepts will be extended to the other forms of fund organizations.\(^{202}\) Several of the prospectuses examined, for example, represented that the sponsor was a fiduciary, although at the same time attempts were made to limit the sponsor’s liability for mismanagement to either willful or gross misconduct or a failure to exercise a good faith judgment.\(^{203}\) However, as others have noted, classification as a fiduciary is only the beginning of analysis,\(^{204}\) and one must seek solutions somewhere between the “punctillio of honor”\(^ {205}\) and the fact that participants

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201. Singletary v. Mann, 157 Fla. 37, 24 So. 2d 718 (1946).

202. In a case in which a co-tenancy arrangement was characterized as a mining partnership, the court said: “[T]hose having the majority interest control its management . . . rendering themselves personally accountable, in an accounting between the partners, for any culpable negligence, or breach of duty, or wrongful conduct, or diversion of the property from the firm’s business to other business in which such managing partner may be interested.” Bartlett & Stardifff v. Boyles, 66 W.Va. 327, 330, 66 S.E. 474, 475 (1909); accord, Stephens v. Allen, 314 Ky. 769, 237 S.W.2d 72 (1951). Other cases have held, without characterizing the arrangement as a mining partnership, that the operator under a typical operating agreement is a fiduciary. E.g., Beadle v. Daniels, 362 P.2d 128 (Wyo. 1961); Midcon Oil & Gas Ltd. v. New British Dominion Oil Co., 21 W.W.R. (n.s.) 228 (App. Div. 1957). The Midcon Oil & Gas case relied on a “joint-venturer” and “principal-agency” characterization of the relationship created. It should be noted that many of the funds examined which utilized co-ownership arrangements disclaimed the existence of any partnership, but often characterized themselves as a “joint-venture.”

203. For a discussion relating to the liability of a sponsor for negligence see text accompanying notes 220-21 infra.

204. “But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligation does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?” SEC v. Chemery Corp., 318 U.S. 80, 85-86 (1943) (Frankfurter, J.).

205. “Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a working at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” Meinhard v. Salmon, 249 N.Y. 468, 463-64, 164 N.E. 545, 546 (1928) (Cardozo, C.J.).
are generally reasonably sophisticated and, in some instances at least, consent to the overall arrangement after full disclosure of the potential conflicts. Extension of the Investment Company Act and other regulatory phases of the securities laws could close some of these gaps, but perhaps at a price that would make it no longer feasible to organize an exploration fund. Within the existing structure of corporate and securities law there is certainly room for courts to scrutinize fairness of prices charged for properties and other services, to prevent the use by the sponsor of information developed with respect to fund properties and to preclude the sponsor from dumping undesirable properties onto the fund. Such scrutiny would, of course, require judicial statesmanship and involve enlightened manipulation as well as application of corporate opportunity, fraud, and fairness concepts. In addition, it would necessitate a further inquiry into the extent to which purchase after disclosure is to be deemed the equivalent of consent and ratification. Since the situations that could arise are so varied and complex, it would be idle to speculate

206. A most attractive solution would regulate transactions between the sponsor and the fund. See text accompanying note 151 supra. However, the proposed amendments to extend the Investment Company Act to exploration funds would be applicable only to a few funds and could be easily evaded by changes in mode of operation. Id.

207. Fiduciary concepts relating to "secret profits" and corporate law doctrines scrutinizing the fairness of transactions with insiders could be applied in the exploration fund context. See H. Henn, Corporations 134-37, 574-77 (1961). The securities laws are also available to sustain a private action in this general area. For example, an investor might allege fraud based on the fund management's failure to disclose an intention to engage in self-dealing, with possible remedies under §§ 11, 12, and 17 of the Securities Act, 15 U.S.C. §§ 77k, 77l(2), 77p (1964), and/or rule 10b-5, 17 C.F.R. § 240.10b-5 (1964), adopted under § 10 of the Exchange Act, 15 U.S.C. § 78j (1964). Further, since the sponsor may be selling the fund a security, see text accompanying notes 147-60 supra, it may be possible to allege—derivatively on behalf of the fund or through a class action—fraud in the sale of the security, utilizing the broad fraud provisions of rule 10b-5. Presumably, a "derivative" action in the case of a partnership would take the form of an action for an accounting. Utilization of the federal securities laws as a basis for such actions would permit the plaintiff to avail himself of the liberal venue and extraterritorial service of process provisions of those laws. Securities Exchange Act § 27, 15 U.S.C. § 78aa (1964). Private actions based upon federal securities laws are in a state of rapid evolution, with ingenious applications being made at a rate that requires an up-to-the-minute scrutiny of the cases and the literature. See generally H. Bloomenthal, Securities Law 401-82 (1968); A. Bromberg, Securities Law Fraud SEC Rule 10b-5 (1967).


210. Unanimous shareholders ratification will generally preclude a derivative action in the case of a corporation, and less than unanimous ratification may estop shareholders who ratify after appropriate disclosure. See H. Henn, supra note 207, at 376, 574-75. A question remains, however, whether a generally phrased advance disclosure of possible conflicts is the equivalent of ratification and/or consent.
concerning results in particular situations. However, in view of the uncertainties in this area, counsel engaged in organizing an exploration fund would be wise to attempt to minimize potential conflicts along the lines that have been suggested, and to the extent that conflicts cannot be avoided, they should be fully disclosed in the prospectus of the fund.

**MISCELLANY**

Except when the corporate or partnership form is utilized, the exploration fund is based on legal doctrines developed primarily in other contexts and lacking a history of application. Accordingly, there are few well defined legal doctrines determining the rights and obligations of the parties in the absence of, and perhaps despite, specific contractual provisions. The lack of precedent necessitates extreme care in drafting the instruments involved and the use of insurance or other means of protecting the participants. The co-ownership joint operating agreement arrangements are particularly vulnerable on this score, with results frequently depending upon whether a particular court will classify such an arrangement as a "mining partnership." While such classification generally depends upon the extent of the co-owners' control over the operator, some courts, in particular contexts, have gone far in finding the necessary control even though, in fact, control appeared to be minimal.²¹¹

If a co-tenancy arrangement is characterized as a mining partnership, the participants, despite the agreement among themselves, will be liable to third parties for the partnership's torts and for contractual obligations incurred on behalf of the partnership.²¹² Liability for fund contracts is likely to arise when the operator-sponsor carries out operations not specifically authorized by the co-owners, or in situations in which the operator-sponsor has failed to pay all of the obligations incurred, despite receipt from the participants of amounts committed by them. Although participants can be

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²¹¹ See, e.g., Mud Control Laboratories v. Covey, 2 Utah 2d 85, 269 P.2d 854 (1954), in which the court regarded a typical operating agreement as establishing the requisite control, despite the fact that the operators had the sole right to explore and develop the land and to hire and control employees. See generally Shepherd, Problems Incident to Joint Ownership of the Oil and Gas Leasehold Estate, 5 OIL & GAS INST. 216 (1954).

²¹² Shell Oil Co. v. Prestidger, 249 P.2d 413 (9th Cir. 1953); Mud Control Laboratories v. Covey, 2 Utah 2d 85, 269 P.2d 854 (1954).
protected against possible tort liability by requiring the operator-sponsor to take out sufficient insurance coverage, the risk of contractual liability under the circumstances outlined may be unavoidable if the operator-sponsor turns out to be irresponsible. Limited protection would be afforded by a provision that all contracts entered into by the operator-sponsor expressly recognize that the obligee is to look solely to the operator-sponsor for payment. Participants, however, are not ordinarily in a position to determine whether such contractual provisions have been included.

There would appear to be no legal reason why participants in an exploration fund should be unable to assign their interests, regardless of the form of organization used. A limited partnership interest is, of course, assignable, although the assignee can be substituted only if the certificate of limited partnership so provides or all of the limited partners consent. In addition, co-tenancy interests can generally be assigned, but subject to the provisions of any outstanding operating agreement. Nevertheless, all but one of the funds examined restricted assignments in some manner. In four of the funds, assignments could be made only with consent; in two others, the sponsor-manager had a right of first refusal to purchase the assigned interest; and in the remaining fund, a partnership arrangement, the limited partnership interest could be assigned, though the assignee could be substituted as a limited partner only with the consent of the general partner. While restrictions on assignment are desirable in connection with a private placement to assure the availability of the private offering exemption, similar restrictions are not compelled by the Securities Act with respect to securities registered thereunder. Restrictions on assignment can also

213. Uniform Limited Partnership Act § 19(5). Substitution also requires an amendment to the certificate of limited partnership. Id. § 25.

214. The typical operating agreement provides that any assignee takes subject to all the terms of the agreement. Although such a provision would presumably have to be recorded in order to affect a purchaser for value without notice, very often operating agreements are not recorded and, in fact, may not be recordable instruments because they are not acknowledged. Absent an effective provision in this regard, the terms of the operating agreement may nonetheless bind assignees as covenants running with the land. See 3 Rocky Mountain Mineral Law Foundation, American Law of Mining § 18.4(e) (1967).

215. See note 169 supra and accompanying text. In order for the non-public offering exemption to be available, the purchaser must not only have access to information upon which to make an intelligent decision, but must also acquire the interest for investment and not with a view to distribution. See generally H. Bloomenthal, supra note 207, at 146-61.
be relevant in avoiding classification as an association, and the consequent taxation as a corporation.\textsuperscript{216} But rather than reflecting tax planning, the principal motivation for such restrictions appears to be either to give the sponsor control over the selection of participants or to give the sponsor the benefit of a right of first refusal.

Those funds which contemplate any continuing obligation of participants to commit monies or of the sponsor to invest such monies generally provide for some form of termination of the fund program in the event further investment would prove futile. Nonetheless, there is rarely any provision made for termination of the continuing relationship that will result if oil and gas are produced.\textsuperscript{217} Since the sponsor is ordinarily the operator under the operating agreement, it presumably will continue to manage the properties and operations as long as they are productive. Yet, provisions are seldom made for selecting successors to the operator and, if the operator should prove irresponsible, the participants do not have well defined legal remedies. There is some authority, however, which would permit a court to remove the operator and appoint a receiver under certain circumstances.\textsuperscript{218} It is possible that partition might also be an effective remedy, but, if utilized, would probably result in a forced sale of the fund property.\textsuperscript{219} Thus, for most purposes the investor-participants in exploration funds have to view themselves as effectively precluded from participation in management and unable to remove management. Accordingly, careful consideration should be given by investors to management’s experience, reputation, and continued availability.

Since there are no well established standards of care required of the manager-sponsor in his performance under an operating agreement or otherwise, most of the funds

\textsuperscript{216} See note 81 supra.
\textsuperscript{217} Funds commonly provide that the operating agreement shall continue in force as long as any oil and gas lease subject to the agreement is still in effect.
\textsuperscript{218} Stephens v. Allen, 314 Ky. 769, 775, 237 S.W.2d 72, 74-75 (1951) (dictum).
\textsuperscript{219} See, e.g., Harper v. Ford, 317 P.2d 210 (Okla. 1957). The right to partition may depend, however, both on how a particular jurisdiction classified mineral interests in property terms and on the provisions of specific statutes relating to partition. See generally Murphy, \textit{A Critique of Partition of Mineral Estate in the United States}, 5 ROCKY MT. MINERAL LAW INST. 543 (1960). The operating agreement employed by one of the funds examined specifically provided that the interest holders were deemed to have waived any right they may have had to seek partition.
examined attempted to provide a contractual standard for this purpose. One fund, for example, provided that the manager should be held to the standard of care to be exercised by independent oil and gas operators, which would appear to be a normal negligence standard.\(^\text{220}\) Two funds specifically provided that the manager would be liable only for acts of gross negligence, fraud, or willful misconduct. Three others deemed that the manager should not be liable for any good faith act or omission on its part provided it exercised its best judgment.\(^\text{221}\) Moreover, two of these three funds provided that the manager would be indemnified for any tort or contract liability it incurred in managing the fund provided it had acted in accordance with the foregoing standard.

The co-ownership arrangements lend themselves to assurances that investors will receive current distributions from production. If production is obtained and each co-owner is named in the division order executed with the purchaser of the oil, remittances will be made directly to the co-owner by the purchaser. The operator typically bills such co-owners for their proportionate share of operating costs. In fact, an arrangement of this type is often necessary in order to avoid having the IRS classify the interest as a net profit interest.\(^\text{222}\) Limited partnerships also should have few problems in dis-

\(^{220}\) In the context in which exploration funds are organized and promoted, it would appear that the sponsors should be held to the standard of care applied generally to one who holds himself out as having special skill and knowledge. See W. PROSSER, TORTS 164 (3d ed. 1964). Much of partnership law relating to intra-partner liability has been developed in the context of small partnerships in which all partners participate in management and none possess special skill. Thus, it is not unusual to find statements such as the following: "A partner is not held to possess the degree of knowledge and skill of a paid agent . . . He is not liable to his partnership for the whole burden of losses caused by errors of judgment and failure to use ordinary skill and care in the supervision and transaction of business." J. CRANE, LAW OF PARTNERSHIP 368 (2d ed. 1952). Compare the following statement made with respect to the managing partner of what the court characterized as a mining partnership: "[T]here is a consequent duty of acting in good faith and with honesty and diligence." Stephens v. Allen, 314 Ky. 769, 773, 237 S.W.2d 72, 75 (1951).

\(^{221}\) It appears that these funds were attempting to establish the lesser standard referred to in note 220 supra with regard to the exercise of due care, and something akin to the "business judgment rule" as to the exercise of judgment. For a discussion of the business judgment rule see H. HENN, supra note 207, at 364-65.

\(^{222}\) The IRS characterizes an arrangement under which the operator advances all costs and then recovers these out of production as an unlimited carry, and equivalent to a net profit interest. See United States v. Thomas, 329 F.2d 119, 130 (9th Cir. 1964); G.C.M. 22,739, 1941-1 CUM. BULL. 214. For the tax consequences of a net profit interest see text accompanying notes 99-141 supra.
tributing cash generated from production to the partners. Care must be taken, however, in the distribution of cash representing a withdrawal of capital, since such a withdrawal by a limited partner without compliance with certain procedures will subject him to unlimited liability. Of the funds examined five appeared to contemplate immediate distributions to the extent that monies were available from production. The other two funds precluded distributions for ten years, and the cash generated was to be reinvested in the organization of new limited partnerships. Although investors in these funds were permitted to withdraw after a minimum period, the "redemption" price substantially discounted the value of their interests.

CONCLUSION

While some exploration fund practices are not completely satisfactory from either a legal or financial viewpoint, such funds play a worthwhile economic role in channeling capital into the development of natural resources. In this article an attempt has been made to chart a course through the somewhat murky legal waters in which exploration funds are organized and operated. In view of the many areas of the law upon which exploration funds touch, the task of putting together such a fund should be a challenging one.

223. See, e.g., Uniform Limited Partnership Act § 16; Wyo. Stat. Ann. §§ 17-251, 17-253 (1957). Under § 16 of the ULPA, a capital withdrawal or reduction can be made only if: (1) all liabilities have been paid or there remains property of the partnership sufficient to pay them, (2) the consent of all members is had, and (3) the certificate is cancelled or so amended to set forth the capital withdrawal or reduction. To the extent that depletion reserves are distributed, they may represent a prohibited withdrawal of capital, and the appropriate statutory procedures should be followed. A few archaic statutes, such as the Wyoming statute cited above, do not include any procedures for withdrawal of capital. Where this type of statute is in force, consideration should be given to organizing the limited partnership under the laws of a state which has adopted the ULPA. However, while there is some authority to the effect that the liability of a limited partner will be determined by the law of the state of organization, e.g., Gilman Paint & Varnish Co. v. Legum, 197 Md. 665, 669, 80 A.2d 906, 908 (1951), authority in this area is sparse, and certainly the state in which operations are being carried on, if the forum state, would have a sufficient interest to justify applying its own law. See generally A. Ehrenzweig, Conflict of Laws 424-25 (1962). Although limited partnership acts generally make no provision for qualifying foreign partnerships, presumably it would be advisable to file and put on record, at the appropriate offices in the state in which operations are being conducted, a copy of the certificate of limited partnership.