

Something Old, Something New: The Evolving Farmout Agreement

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I. INTRODUCTION

The three most important instruments for oil and gas development have been and continue to be the oil and gas lease, the joint operating agreement, and the farmout agreement. Of the three, the lease is by far the most senior,¹ and it has received the most analysis by commentators and the courts. However, as Professor John Lowe notes in his comprehensive article on farmout agreements,² since the end of World War II, the oil and gas farmout has become nearly as important as the oil and gas lease. He believes this is in part a reaction to the increased risks and costs of deeper drilling and the proliferation of small oil companies anxious to make deals with their larger brethren.³ This article will define a farmout agreement, review the basis for its structure (the goals of the parties and applicable tax law), and identify its key characteristics. It will then address selected issues involving farmouts, with an emphasis on recent cases. Finally, it will consider the evolution of the farmout agreement from the simple, one- or two-page document first used by the parties to develop a single-well prospect, to the complex, multi-paged, multi-faceted document used today to develop large exploration plays, that involve increased costs and risks that have fundamentally altered the form of the agreement.

II. DEFINITION OF A FARMOUT AGREEMENT

An oil and gas farmout agreement has been defined as “an agreement by one who owns drilling rights to assign all or a portion of those

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1. The lease under which the United State's first well, the Drake well, was drilled was dated December 30, 1857. 2 THE DERRICK'S HAND-BOOK OF PETROLEUM 191 (1900). The first AAPL Model Form Operating Agreement was published in 1956. There is no certainty when the first farmout agreement was executed, but the term “farmout” was in common use by the 1940s. See, e.g., Petroleum Fin. Corp. v. Cockburn, 241 F.2d 312, 314 (5th Cir. 1957); Honolulu Oil Corp. v. Tex. Pac. Coal & Oil Co., 141 F. Supp. 322, 323 (N.D. Tex. 1956).

2. See John S. Lowe, *Analyzing Oil and Gas Farmout Agreements*, 41 Sw. L.J. 759 (1987).

3. *Id.* at 762. See *infra* Part VI for a discussion of how the use of farmout agreements has evolved over the twenty-three years since Professor Lowe published his article.

rights to another in return for drilling and testing on the property.”⁴ The entity that owns the drilling rights is the “farmor,” while the entity that receives the right to drill is the “farmee.”⁵ A farmout agreement differs from an operating agreement. Under a farmout agreement, the farmee is seeking to earn an interest in the farmor’s lease, while the parties to an operating agreement already own joint interests in a lease or leases or in the contract area and agree to combine these interests for joint operations.⁶ Another distinction is that the farmee “carries” the farmor—pays the farmor’s share for all or a part of the costs to drill the well—while the parties to an operating agreement share such costs “heads up,” or in proportion to their respective ownership interests in the lands covered by the operating agreement.⁷

III. STRUCTURE OF THE FARMOUT

A. Goals of the Parties

The structure of a farmout agreement and its essential terms are determined by two considerations: the goals of the parties entering into the agreement and the applicable tax rules.⁸ The farmor may have a variety of reasons for wishing to farmout its interest. In his 1987 article, Professor Lowe identified seven factors that may motivate the farmor: (1) lease preservation; (2) lease salvage (for example, monetizing a prospect that the farmor has condemned); (3) risk sharing; (4) obtaining geological information to evaluate other leases held by the farmor or to delineate a “play”; (5) access to the farmor’s market for the sale of the farmee’s production; (6) securing reserves to fill the farmee’s transportation or refining needs; and (7) drilling an “obligation well” (for example, a well required to prevent drainage, to further develop the leasehold, or to prevent the application of a Pugh clause).⁹ Today, because of deregulation and the ability to hedge, access to the farmor’s market is

4. *Id.* at 762; see also Earl A. Brown, *Assignments of Interests in Oil and Gas Leases: Farm-Out Agreements, Bottom Whole Letters, Reservations of Overrides and Oil Payments*, 5 INST. ON OIL & GAS L. & TAX’N. 25, 69-70 (1954).

5. In his seminal article, Professor Lowe notes:

The origin of the term “farmout” is not clear. Professor Hemingway has said that the term’s use goes as far back as ancient Roman times, when the state transferred the right to collect certain taxes to private individuals who received a fee for their services. Other commentators have attributed “farmout” to the term used in baseball “Like the rookie ball player who may be farmed out to a minor league team for further training, an oil and gas lease may be farmed out for development.”

Lowe, *supra* note 2, at 763-64 (citing C. RUSSELL & R. BOWHAY, INCOME TAXATION OF NATURAL RESOURCES ¶ 7.02 (1986); Richard W. Hemingway, *The Farmout Agreement: A Short Story but Not Always Sweet*, 1985 A.B.A. SEC. NAT. RESOURCES AND ENV’T 3).

6. *Id.* at 764.

7. *See id.*

8. *Id.* at 765.

9. *Id.* at 778. For a discussion of each of these factors, see *id.* at 778-82.

not as important as it was in 1987. Similarly, securing reserves is less of a concern because, in normal circumstances, there are ample supplies of gas for pipelines to transport and crude for refiners to process.

The factors Professor Lowe identified in 1987 that may motivate the farmee's decision to enter into a farmout included: (1) quickly acquiring an acreage position or obtaining reserves; (2) using available cash, equipment, or personnel (particularly if the farmee or its affiliate is a drilling services company); (3) positively evaluating a prospect that the farmor has dismissed; and (4) desiring to become active in the area while sharing the risks.¹⁰ In the present environment, at least with respect to the farmouts covering substantial acreage that are discussed in Part VI, the desire to enter a new area, but to share the risks, is of paramount importance.

B. Applicable Tax Rules

Complicated tax rules govern the structure of a farmout agreement and dictate its terms. The following discussion summarizes the applicable tax rules.¹¹ A farmout agreement is "a form of sharing arrangement."¹² The essential feature of the agreement is that "one party makes a contribution to the acquisition, exploration or development of an oil and gas property" and in return is given a share of the production from the property to which the contribution is made.¹³ A party's contribution may be of acreage, money, goods or services, while the share of production transferred may be a working interest, a carried or net-profits interest, an overriding royalty, or a production payment.¹⁴ "[T]he contribution must be to the property in the production of which the contributor is given an interest[.]" and if the contribution is money, it must be made or agreed to before the costs have been incurred.¹⁵

The contributor in a sharing arrangement has made a capital investment, and it acquires a depletable interest in the production.¹⁶ The contributor and the recipient do not realize taxable income or loss from the contribution or transfer because the transfer of a property interest for development is treated as the formation of a new economic venture rather than a sale of property or services.¹⁷ If, as is the case with most farmouts, the farmee receives an operating interest for its contribution,

10. *Id.* at 782.

11. For a detailed analysis of the tax treatment of farmouts, see 2 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 433.1 (2009); Lowe, *supra* note 2, at 765-78.

12. 2 MARTIN & KRAMER, *supra* note 11, § 432.3.

13. *Id.* § 433.

14. *Id.*

15. *Id.*

16. *Id.* § 433.1 (citing G.C.M. 22730, 1941-1 C.B. 214.).

17. *See id.*

the tax consequences depend on whether the entire operating interest or an undivided share of such interest is transferred to the farmee.¹⁸ When the farmee receives the entire working interest, it may deduct all of the intangible drilling cost(s) (IDC)¹⁹ it pays to drill and complete the well against current income, so long as there is no possibility that the farmee's working interest in the drillsite acreage will end before complete payout of the costs of drilling, completing, and operating.²⁰ The IDC deduction is a very important incentive to the oil and gas industry because IDC typically amount to between 50% and 80% of the total costs of drilling and completing a well.²¹ "The IDC deduction allows investors to drill up their profits at the end of each year."²²

In 1977, the Internal Revenue Service (IRS) changed the rules of the game for farmouts with Revenue Ruling 77-176.²³ The ruling "modified application of the sharing arrangement concept to farmouts that involved transfers of interests in acreage outside of the well site by declaring the well site acreage and the outside acreage to be separate properties."²⁴ The IRS treated the interest in the acreage outside of the well-site acreage as a separate transfer subject to tax because the farmee made no contribution to the development of the outside acreage.²⁵ Therefore, the farmor realizes taxable income equal to the difference between its basis in the outside acreage assigned and the fair market value of such acreage. The farmee is also deemed to have received taxable income equal to the fair market value of such outside acreage because it made no capital investment in such acreage. Thus, both parties realize "phantom income" from the transaction.²⁶ There are a variety of devices that avoid or minimize the impact of Revenue Ruling 77-176.²⁷ The most popular of these devices is the tax partnership.²⁸ The partnership is formed for tax purposes rather than for state property law purposes because the parties would then be exposed to joint and several liability.²⁹ Section 721 of the Internal Revenue Code is used to designate both the well-site acreage and the additional acreage as the "property"

18. *Id.*

19. "Intangible drilling costs include the costs of wages, fuel, repairs, hauling, and supplies used in drilling, fracturing and cleaning wells, site preparation, and construction of derricks, tanks and pipelines necessary for the drilling and preparation of wells for production." Lowe, *supra* note 2, at 766. The general rule of thumb is that an intangible drilling cost (IDC) expense is anything associated with drilling that has no salvage value (excluding pipe and surface equipment). *See id.* Items with salvage value are capitalized.

20. *See* Rev. Rul. 80-109, 1980-1 C.B. 129.

21. Lowe, *supra* note 2, at 766.

22. *Id.* (citing RUSSELL & BOWHAY, *supra* note 5, ¶ 14.11-A.).

23. Rev. Rul. 77-176, 1977-1 C.B. 77.

24. Lowe, *supra* note 2, at 769. (citing Rev. Rul. 77-176, 1977-1 C.B. 77).

25. *Id.*

26. *Id.* at 770.

27. *See id.* at 770-78 (discussing the suggested devices).

28. *Id.* at 776.

29. *See id.*

of the tax partnership.³⁰ To accomplish this designation, the parties must stipulate in the farmout agreement not to elect out of subchapter K of the Internal Revenue Code and agree to allocate income and deductions on a partnership return.³¹

IV. KEY CHARACTERISTICS OF THE FARMOUT AGREEMENT

In his 1987 article, Professor Lowe identified five key characteristics of, or areas covered by, a traditional farmout agreement.³² The following analysis will address these key characteristics and discuss their relevance to farmouts made in today's environment.

The first characteristic identified by Professor Lowe is the "duty imposed."³³ An option farmout agreement provides that the farmee must drill the well in order to earn the agreed-to-interest but that there is no penalty if it elects not to drill, other than the loss of the right to earn.³⁴ An obligation farmout agreement, on the other hand, obligates the farmee to drill the well.³⁵ If the farmor's purpose for making the farmout is to have an obligation-well drilled, it will likely structure the transaction as an obligation farmout.³⁶ If the farmor is motivated by other purposes, the transaction may be structured as an option.³⁷ For obvious reasons, potential farmees are likely to prefer to have the option to drill the well, rather than the obligation, and the farmor may have to structure the transaction accordingly in order to encourage the farmee to take the farmout. In the present environment, except in the case of a one-well farmout, the farmor's main goals in making the farmout are likely to be obtaining geological information and/or sharing exploration risks. Therefore, it will seek to obligate the farmee to drill in order to satisfy these goals.³⁸

The second key characteristic of a farmout identified by Professor Lowe is the "earning factor."³⁹ A produce-to-earn farmout agreement provides that the farmee earns an interest in the property only if it completes a well capable of producing in paying quantities.⁴⁰ Conversely, a drill-to-earn farmout only requires that the farmee drill to the specified formation and conduct the agreed-upon testing in order to earn the in-

30. 26 U.S.C. § 721 (2006).

31. Lowe, *supra* note 2, at 777.

32. *See id.* at 792.

33. *Id.*

34. *Id.* at 792-93.

35. *Id.*

36. *See* 2 MARTIN & KRAMER, *supra* note 11, § 432.

37. Lowe, *supra* note 2, at 793.

38. *See* discussion *infra* Part VI.

39. Lowe, *supra* note 2, at 792.

40. *Id.* at 793; *see also* *Lansinger v. United Petroleum Corp.*, 471 N.E.2d 869 (Ohio Ct. App. 1984).

terest.⁴¹ If the purpose of the farmor is to drill an obligation well in order to preserve the lease, the farmout is likely to be a produce-to-earn.⁴² If it is motivated by a desire to explore and/or to obtain geological data, it is more likely to be a drill-to-earn.⁴³

Another key characteristic identified by Professor Lowe is the type of “interest earned”—divided, undivided, or combined.⁴⁴ A divided interest farmout results “in the farmor and farmee owning interests in separate tracts.”⁴⁵ A good example is when the farmee earns the entire interest in the drillsite tract for drilling the well and the lessor retains the entire interest in the leasehold acreage outside of the drillsite tract.⁴⁶ A variation of this is a “checkerboard” assignment when the farmee earns the entire interest in the drillsite acreage plus the entire interest in every other drillsite unit surrounding the drillsite tract.⁴⁷

An undivided interest results in the farmee and farmor each owning an interest in the tract; to illustrate, the farmee earns a 75% interest in the tract for paying 75% of the drilling costs.⁴⁸ This is frequently the result when the farmor needs additional cash to drill the well or when the farmor wishes to share the risks in case the well is a dry hole. A combination of undivided and divided interests gives the farmee the entire interest in the drillsite tract until payout and an undivided interest in acreage outside of the drillsite tract.⁴⁹ The parties then jointly develop the undrilled acreage. This is frequently the case when the object is to test large undeveloped tracts.⁵⁰

Another key area addressed in the farmout agreement is the number of wells that are subject to the agreement.⁵¹ The typical farmout agreement in 1987 covered the drilling of a single well.⁵² Today, the opportunity to drill multiple wells is the norm.⁵³ A multiple-well farmout

41. Lowe, *supra* note 2, at 793; *see also* EOG Resources, Inc. v. Wagner & Brown, Ltd., 202 S.W.3d 338 (Tex. App. 2006).

42. *See, e.g.*, Socony Mobil Oil Co. v. Cont'l Oil Co., 335 F.2d 438, 439 (10th Cir. 1964).

43. *See, e.g.*, Lansinger, 471 N.E.2d 869; Moncrief v. La. Land & Exploration. Co., 861 P.2d 516, 520 (Wyo. 1993); *see also* Claude L. Vander Ploeg, *Particular Problems in the Structuring of Broad Area Exploration Contracts*, 5 E. MIN. L. INST. 14-1 (1984).

44. Lowe, *supra* note 2, at 794.

45. *Id.*; *see also* Amoco Prod. Co. v. Hugoton Energy Corp., 11 F. Supp. 2d 1270, 1272 (D. Kan. 1998).

46. Lowe, *supra* note 2, at 794.

47. *Id.* For examples of checkerboard assignments, *see Strata Production Co. v. Mercury Exploration Co.*, 916 P.2d 822, 826 (N.M. 1996); *Stekoll Petrol. Co. v. Hamilton*, 255 S.W.2d 187, 190-91 (Tex. 1953).

48. Lowe, *supra* note 2, at 794.

49. But this may result in adverse tax consequences. *See* discussion *supra* Part III.B.

50. Lowe, *supra* note 2, at 794; *see, e.g.*, *Amoco*, 11 F. Supp. 2d at 1272; *see also* Cyrus Santi, *Total Joins Chesapeake in Gas Joint Venture*, NY TIMES, Jan. 4, 2010, <http://dealbook.blogs.nytimes.com/2010/01/04/total-joins-chesapeake-in-gas-joint-venture/?pagemode=print> (reporting on a recent \$2.25 billion joint venture in natural gas fields in Texas between Chesapeake Energy and French oil giant Total).

51. Lowe, *supra* note 2, at 792.

52. *See id.* at 795. Professor Lowe describes this as a “classic” farmout arrangement. *Id.*

53. *See infra* Part VI.

agreement may address, among other things: the time between the completion of a well and the commencement of the drilling of the next well; the testing required; the interest earned by the farmee if it stops drilling; and whether the drilling of subsequent wells is an option or an obligation.⁵⁴

The final characteristic of a farmout agreement identified by Professor Lowe is the timing of issuing the assignment of the farmout acreage.⁵⁵ A farmout agreement will either provide for an assignment of the farmed-out interest at the time the farmout agreement is entered into by the parties, subject to reconveyance if the farmee fails to perform or will provide that the assignment will be made only if the farmee performs the condition precedent—the drilling of the well.⁵⁶ If the farmout is in the form of a conditional assignment, the farmee acquires an interest in the farmed-out property when the agreement is made, subject to an obligation to reconvey if it fails to perform.⁵⁷ Administratively, the farmor will prefer to wait to make the assignment until the farmee performs so it does not have to track down the farmee to get a re-assignment and clear title.⁵⁸ On the other hand, the farmor would prefer to receive an upfront recordable assignment in case the farmor assigns an interest to another party prior to the farmee drilling the well, thereby revoking the farmout if it is an option farmout.⁵⁹ Also, if the farmor should file for bankruptcy prior to making the assignment, the farmee may never receive the assignment.⁶⁰ When Professor Lowe wrote his definitive article on farmouts in 1987, a conditional assignment may have been a real possibility; but today, in the author's experience, it is quite unusual for an assignment to be made prior to the farmee earning it by drilling the obligation well.⁶¹

V. SELECTED ISSUES

Oil and gas practitioners have not standardized farmout agreements to the degree they have done so with the joint-operating agreement and the oil and gas lease. Early farmout agreements tended to be on the basis of informal “letter agreements,” often on a single page or

54. Lowe, *supra* note 2, at 795.

55. *See id.* at 796.

56. *Id.*

57. *Id.*

58. *Id.*

59. *See, e.g.,* Strata Prod. Co. v. Mercury Exploration. Co., 916 P.2d 822, 829-30 (N.M. 1996) (applying the doctrine of promissory estoppel to defeat the farmor's argument that the farmout terms had been modified prior to the drilling of the well).

60. *Cf. In re J.H. Land & Cattle Co.*, 8 B.R. 237 (W.D. Okla. 1981) (allowing debtor-lessor to reject eleven leases and grant new leases on more advantageous terms under “business judgment test”).

61. Ann Lane, Senior Counsel, The Williams Company, Inc., Denver, Colorado, reports that her company would never make a conditional assignment.

two, that failed to address or fully express the terms covering many key areas.⁶² Often the “agreement” consisted of an exchange of letters that may or may not have constituted a binding contract.⁶³ It was sometimes difficult to determine whether the parties were still negotiating or whether a deal had been struck. As the court observed in *Petroleum Financial Corp. v. Cockburn*.⁶⁴

Not uncommon in these operations where the object is to bring together one who has, or can procure, acreage, (mineral leases) and the one, or many, who will supply the large risk capital required, the transaction is marked by great informality amongst a stratified succession of interested parties, each of whom cuts off a slice (e.g., overriding royalty, etc.) then sells all or a part of the rights to another.⁶⁵

For example, in *Smith v. Sabine Royalty Corp.*,⁶⁶ the owner of a 1/6 mineral interest wrote a letter to the owners of the remaining 5/6 interest that stated, “[i]f you elect to proceed with the drilling of the Morrortest in Section 9, we would be willing to grant an oil and gas lease . . . with the lease to provide for 1/4 royalty . . . [and] a 50% backin [sic] option at payout of the well.”⁶⁷ The letter concluded, “[i]f you wish to pursue this arrangement, please let us know and the appropriate instruments will be forwarded for your approval.”⁶⁸ The 5/6 owners did not respond to the letter until after they had drilled the well as a producer.⁶⁹ They then contacted the 1/6 owner and requested an assignment of the lease.⁷⁰ The court held that the letter from the 1/6 owner was merely an invitation to further negotiate and did not constitute an offer that could be accepted by drilling the well.⁷¹

Compare the court’s reasoning in *Sabine* with that of the New Mexico Supreme Court in *Strata Production Co. v. Mercury Exploration Co.*⁷² In *Strata*, Mercury and Strata entered into a farmout agreement in which Mercury represented that it owned or controlled all of the Lechuza tract and that it would assign to Strata a net revenue interest of 76.5% in the tract if Strata initiated the drilling of a test well on the tract within 120 days of entering into the agreement.⁷³ Two months after signing the agreement with Mercury, Strata drilled an expensive and

62. See generally E. Dale Trower, *Enforceability of Letters of Intent and Other Preliminary Agreements*, 24 ROCKY MT. MIN. L. INST. 347 (1978).

63. Compare *Getty Oil Co. v. Blevco Energy, Inc.*, 722 S.W.2d 51, 54 (Tex. App. 1986) (holding parties never reached a “mutually acceptable agreement”) with *Chevron v. Martin Exploration Co.*, 447 So.2d 469, 473 (La. 1984) (holding contract was binding despite its designation as “preliminary”).

64. 241 F.2d 312 (5th Cir. 1957).

65. *Id.* at 313.

66. 556 S.W.2d 365 (Tex. Civ. App. 1977).

67. *Id.* at 367.

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 368.

72. 916 P.2d 822 (N.M. 1996).

73. *Id.* at 825.

risky exploratory well on the adjoining Cercion tract under a farmout agreement from Exxon.⁷⁴ While it was drilling this well, Strata's title attorney determined "that Mercury did not own 100% of the working interest in the Lechuza tract, nor was it able to transfer a 76.5% net revenue interest" in the tract.⁷⁵ After attempting to obtain farmouts from the newly discovered interest owners and being denied a second extension of time by Mercury to drill the initial test well, Strata proceeded to drill three wells on the Lechuza tract, two of which were productive.⁷⁶ It then sued Mercury for breach of contract and negligent misrepresentation for failing to deliver the promised interests.⁷⁷ Mercury defended on the basis that the "farmout agreement with Strata was a unilateral contract [that] it was free to revoke or modify before Strata's acceptance" and "that Strata's discovery of Mercury's inability to transfer . . . the relevant interests" acted to modify its original offer.⁷⁸ The court agreed with Mercury that the farmout agreement was an option contract that had to be supported by consideration in order to be irrevocable for the stated period of time and that Strata had not paid Mercury anything for the farmout.⁷⁹ However, it found that the doctrine of promissory estoppel⁸⁰ applied to make the offer irrevocable for the option period because Strata had begun drilling on the Cercion tract in reliance on the Mercury farmout prior to learning of Mercury's inability to deliver the promised interests.⁸¹

A farmout agreement must also sufficiently describe the lands that are subject to the agreement in order to meet the standards of the statute of frauds. For example, in *Westland Oil Development Corp. v. Gulf Oil Corp.*,⁸² an area of mutual interest (AMI) clause in a letter agreement assigning the farmee's rights under a farmout agreement provided that if any of the parties acquired any additional leasehold interests affecting "the lands covered by said farmout agreement, or any additional interest . . . under lands in the area of the farmout acreage," the interests acquired would be subject to the provisions of the AMI.⁸³ The farmout well that was drilled was marginal, but it earned the acreage.⁸⁴ The assignment of the leases in the farmout block referred to an operating

74. *Id.* at 826.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 827.

79. *Id.*

80. The court stated that the elements of promissory estoppel are: (i) a promise has been made, (ii) the promisee's reliance is reasonable, (iii) the promisee's action or forbearance resulted in a substantial change in position, (iv) the promisee's action or forbearance must have been reasonably foreseeable, and (v) enforcement of the promise is necessary to prevent injustice. *Id.* at 828.

81. *Id.* at 829-30.

82. 637 S.W.2d 903 (Tex. 1982).

83. *Id.* at 905.

84. *Id.*

agreement executed by the parties that covered the assigned lands.⁸⁵ The operating agreement, in turn, referred to the farmout agreement and the letter agreement.⁸⁶ Of all of these documents, only the assignment was filed of record.⁸⁷ The court held that the defendants, who were remote successors-in-interest to the original farmee, as prudent purchasers, should have reviewed the terms of the operating agreement referred to in the recorded assignment. Therefore, the defendants were charged with notice of such terms, including the existence of the farmout agreement and the letter agreement with the AMI.⁸⁸ However, the court further held that the defendants' acquisition of acreage outside of the three sections specifically described in the farmout agreement was not subject to the AMI provisions because the reference to "lands in the area of the farmout acreage" was not sufficiently explicit to satisfy the statute of frauds.⁸⁹

The parties to a farmout agreement also must be cognizant of the provisions in the leases assigned and be mindful of their compliance with these provisions. For example, in *Isler v. Texas Oil & Gas Corp.*,⁹⁰ the agreement provided that the farmor would make delay-rental payments on the federal lease assigned or would give the farmee notice before ceasing to make them.⁹¹ It further provided that the farmor would have no responsibility to the farmee for failing to make such payments.⁹² The farmor, through oversight, failed to make delay rental payments and the lease expired.⁹³ The farmee drilled two dry holes on the lease lands after the lease expired and before it was notified of such expiration.⁹⁴ It sued the farmor for breach of contract and for damages caused by its negligence.⁹⁵ The United States Court of Appeals for the Tenth Circuit reversed a jury award for the farmee, holding that the exculpatory provision in the farmout agreement meant what it said.⁹⁶

A number of recent decisions have demonstrated the importance of careful drafting when preparing the farmout agreement. For example,

85. *Id.* at 905-06.

86. *Id.* at 906.

87. *Id.*

88. *Id.* at 908.

89. *Id.* at 910; *see also* *Stekoll Petroleum Co. v. Hamilton*, 255 S.W.2d 187, 191-92 (Tex. 1953) (The court found that under the statute of frauds the contract was unenforceable. The defendant was granted the option to acquire leases on 4,000 acres of a 5,000 acre block leaving the plaintiff with 1,000 acres "equitably checker-boarded.").

90. 749 F.2d 22 (10th Cir. 1984).

91. *Id.* at 22.

92. *Id.*

93. *Id.*

94. *Id.*

95. *See id.*

96. *Id.* at 24; *see also* *Davis v. Zapata Petroleum Corp.*, 351 S.W.2d 916 (Tex. Civ. App. 1961) (involving a farmout agreement that did not take into account lease provision that prohibited cessation of drilling operations).

in *EOG Resources, Inc. v. Wagner & Brown, Ltd.*,⁹⁷ the court held that the earning provision in the farmout agreement that specified “100 feet below the deepest producing interval” referred to the vertical depth of the test well rather than the geological formation at which production was established at whatever depth such interval is found.⁹⁸ Similarly, in *Osborn v. Anadarko Petroleum Corp.*,⁹⁹ the farmee contended that, pursuant to a provision in the farmout agreement, it was entitled to convert its overriding royalty into a 50% working interest because the farmor had abandoned the test well.¹⁰⁰ On appeal, the court held that “conversion of an oil and gas well from extraction to water injection for purposes of secondary recovery operations, when [the] well is part of a pooled unit and retains its share of production in the unit, does not constitute abandonment.”¹⁰¹

A re-occurring issue in litigation involving farmouts is the duty owed the farmor by the farmee. In *Energen Resources MAQ, Inc. v. Dalbosco*,¹⁰² the plaintiff farmed out its interest in several leases to the defendant’s predecessor-in-interest and, pursuant to the farmout agreement, acquired a 25% working interest in the well drilled on the farmout acreage following payout of the well.¹⁰³ There was no operating agreement governing operation of the well.¹⁰⁴ The defendant plugged and abandoned the well without first notifying the plaintiff and giving it an opportunity to assume the operation of the well.¹⁰⁵ The court held that, even though the farmout agreement was silent on the matter, the defendant breached its duty to notify the plaintiff that it intended to cap the well because industry custom and usage required such notice.¹⁰⁶

In *Amoco Production Co. v. Texaco, Inc.*,¹⁰⁷ the plaintiff “sub-leased” its interest in five leases to defendants’ predecessor-in-title.¹⁰⁸ The sublease provided that if the sublessee intended to surrender, let expire, or release its rights in any part of the lease acreage, it would provide the sublessor with not fewer than sixty days advance notice thereof and, if so requested by the sublessor, reassign its rights in such portion

97. 202 S.W.3d 338 (Tex. App. 2006).

98. *Id.* at 345-47.

99. 996 P.2d 9 (Wyo. 2000).

100. *Id.* at 10.

101. *Id.* at 13.

102. 23 S.W.3d 551 (Tex. App. 2000).

103. *Id.* at 553.

104. *Id.*

105. *Id.*

106. *Id.* at 556. *But see* Sawyer v. Guthrie, 215 F. Supp. 2d 1254, 1262-63 (D. Wyo. 2002) (holding that the farmee had no implied duty to continuously develop the leasehold so that no part of the lease would be allowed to expire).

107. 838 So. 2d 821 (La. App. 2003).

108. *Id.* at 825 n.1.

of the lease acreage to the sublessor.¹⁰⁹ The defendants subsequently abandoned the unit well and allowed the non-producing portion of the leases to expire without first notifying the plaintiff.¹¹⁰ Because only the non-producing portion of the leases were released, there was no significant decrease in the royalties received by the plaintiff so as to alert it to the defendants' actions.¹¹¹ The defendants then acquired new leases covering the released acreage.¹¹² New gas deposits underlying the acreage were discovered, generating millions of dollars in revenue.¹¹³ Sixteen years after the lease acreage was first released, the plaintiff learned of the lease cancellations and sued the defendants.¹¹⁴ On appeal, the court upheld a \$30,000,000 damage award for the defendants' failure to give the plaintiff prior notice before allowing a portion of the leases to expire in breach of the sublease.¹¹⁵

Another fertile area for litigation involving farmouts is the calculation of "payout." For example, in *Continental Oil Co. v. American Quasar Petroleum*,¹¹⁶ the court held that all expenses incurred as a result of a well blowout were recoverable by the farmee through the "payout" account, notwithstanding that the risk had been covered by insurance.¹¹⁷ The court reached this conclusion because well-blowout insurance was not required by the farmout agreement and the premiums would not have been a recoverable cost under the agreement.¹¹⁸

An interesting case that was recently argued before the Wyoming Supreme Court, *Hartman v. Ultra Resources, Inc.*,¹¹⁹ dealt with a document styled as an "Agreement for Assignment of Novi Leases and for a Net Profits Interest."¹²⁰ However, the document contained many of the characteristics of a farmout agreement.¹²¹ In *Hartman*, the plaintiffs' predecessor-in-interest assigned leases covering approximately 6,000 acres to the defendants' predecessors-in-interest to be committed to the

109. *Id.* at 826.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.* at 827.

115. *Id.* at 841; *see also* EOG Res., Inc. v. Hanson Prod. Co., 94 S.W.3d 697, 702 (Tex. App. 2002) (holding the farmout agreement and the subsequent assignment had to be read together to determine the parties' intent as to whether the farmer's retained override burdened extensions and renewals of the subject leases).

116. 599 F.2d 363 (10th Cir. 1979).

117. *Id.* at 365.

118. *Id.* at 364-65; *see also* Mengden v. Peninsula Prod. Co., 544 S.W. 643, 648 (Tex. 1976) (holding that for purposes of calculating payout, production from two pooled units was not to be allocated entirely to the farmout of the lease on which the wells were located).

119. No. S-08-0262 (Wyo. filed Dec. 10, 2008). *Hartman* is one of seven cases consolidated on appeal by the Wyoming Supreme Court and argued on May 14, 2009. *See* the *Hartman* case file online at <https://efiling.courts.state.wy.us/public/caseView.do?csIID=10894>.

120. Brief of Plaintiff-Appellant at 8, *Hartman v. Ultra Resources Inc.*, No. S-08-0262 (Wyo. Jan. 27, 2009).

121. *See supra* Part IV for a discussion of these characteristics.

90,000-acre Pinedale Unit, which was approved by the U.S. Geological Service (now the Bureau of Land Management (BLM)) in 1954 shortly after the assignment was made.¹²² The assignor retained a net profits interest (NPI) of 5% of the net profits from unit operations.¹²³ The Pinedale Unit was terminated by the BLM in 1981, but many of the original leases were committed to successor units.¹²⁴ The Pinedale Unit, which consisted primarily of shallow gas wells, never produced a profit.¹²⁵ But, beginning with the deeper gas discoveries in the late 1990s and as a result of higher gas prices due to deregulation and economic growth, the NPI, if it continued to exist with respect to the originally committed leases, became quite valuable.¹²⁶ Among the issues argued before the court was whether the agreement creating the NPI expired with the termination of the Pinedale Unit or, as the district court held when it granted plaintiffs' motion for partial summary judgment, the NPI was lease-based and continues to burden the originally committed leases that are still in effect.¹²⁷ As of the publication of this article, the decision is pending.

VI. CONCLUSION: EVOLUTION OF THE FARMOUT AGREEMENT

Farmout agreements have evolved over time.¹²⁸ As stated above, early farmout agreements were generally quite brief and might have consisted of an exchange of telexes.¹²⁹ Today's farmout agreement, however, is likely to be much more complex and far-reaching.¹³⁰ One observer has characterized today's form of agreements as "Fat Farmouts," with the same problems associated with earlier farmouts, only

122. See Brief of Plaintiff-Appellant, *supra* note 120, at 9.

123. *Id.* at 10.

124. *Id.* at 16-17.

125. Interview with Eric Dady, Gen. Counsel, Questar Mkt. Res., Inc. in Denver, Colo. (May 18, 2009).

126. *Id.*

127. Brief of Plaintiff-Appellant, *supra* note 120, at 1.

128. Compare *Honolulu Oil Corp. v. Tex. Pac. Coal & Oil Co.*, 141 F. Supp. 322, 323 (N.D. Tex. 1956) (involving a "typewritten farmout letter cover[ing] three letter size sheets"), with *Amoco Prod. Co. v. Hugoton Energy Corp.*, 11 F. Supp. 2d 1270, 1272 (D. Kan. 1998) (involving a comprehensive farmout agreement covering leases in five counties).

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129. See, e.g., *Petroleum Fin. Corp. v. Cockburn*, 241 F.2d 312, 312 (5th Cir. 1957) (holding that the "contract, as evidenced by an exchange of telegrams, was so ambiguous as to permit introduction of parol evidence, and such evidence sustained finding that there was no breach of contract").

130. A good example of this type of agreement is found in *Amoco Prod. Co.*, 11 F. Supp. 2d 1270, in which the farmout covered the farmor's leasehold interests in five counties, which were divided into ten nine-section drilling blocks, for the drilling of exploratory wells and development wells. See also *Stekoll Petroleum. Co. v. Hamilton*, 255 S.W.2d 187 (Tex. 1953).

bigger.¹³¹ These Fat Farmouts are not modeled on the traditional form of farmout agreements and are likely to be designated as a Participation Agreement, an Exploration Agreements, or Joint Venture Agreements to distinguish them from their more modest predecessor. Yet, the key areas covered by the traditional farmout agreement¹³² are also covered in these documents.¹³³ In the current environment, the majors are not particularly concerned with saving individual leases and are interested in entering into a farmout agreement only if the agreement covers a substantial amount of acreage and involves an exploration play. In this case, they use the farmout to gather information and/or to reduce their risk in the early stages of the play. For a non-shale play covering a large amount of acreage, today's standard farmout terms call for the farmee to drill a specified number of wells on its own, and the parties then participate together in drilling the rest. For a shale play, the farmor may want to be carried to casing point or to the tanks so that it can have immediate participation, assuming that it controls or has the ability to control a large percentage of the play and has the resources necessary to fund its participation.¹³⁴ In both cases, one of the farmor's primary goals is to obtain seismic data and/or well information.

For an exploration play that is a true "wildcat" (a play that has not been delineated), there is great reluctance to farm out all of the acreage that may be part of the play without retaining the ability to participate in case the farmee is successful in establishing production. Similarly, in a play that is beyond the exploration stage but is not yet in a development mode, the farmor will want to be careful that it is not farming out acreage that contains the "sweet spot." Instead, it will want to farmout acreage that it believes is marginally prospective and will generate information that will help it to identify the location of the prime acreage to develop.

If there is not a significant amount of undeveloped acreage available, but a party is willing to farmout its interest that does not meet its hurdle rate to develop, some companies prefer to retain a permanent override that is not convertible to a back-in interest. These companies reason that there are not enough dollars involved to justify the administrative costs of tracking the payout account and that the retention of a

131. Milam Randolph Pharo, Senior Vice President and General Counsel, St. Mary Land & Exploration Company, Denver, Colorado, Speaker at the Washburn University School of Law Symposium: The Future Course of Oil & Gas Jurisprudence II (Oct. 2-3, 2009).

132. See *supra* Part IV for a description of these areas.

133. A good example of using the traditional farmout as a basis for structuring the development of a large exploration play is found in the recently announced joint venture between French oil giant, Total, and Chesapeake Energy to develop Chesapeake's Barnett shale gas portfolio in Texas. See Sanati, *supra* note 50.

134. See Michael J. Byrd et. al., *Common Legal Issues in U.S. Shale Plays*, 34 OIL, GAS AND ENERGY RESOURCES L. SEC. REP. 3, 14-16 (December 2009).

non-cost bearing interest avoids the liability for plugging the well.¹³⁵

Today's farmout agreement is likely to have as many provisions dealing with risk management concerns as those covering the key areas of traditional farmout agreements.¹³⁶ Thus, a contemporaneous farmout agreement will have detailed provisions dealing with bonding and insurance requirements, environmental protection, including specific mitigation requirements, and may require the farmee to escrow funds to cover its obligations. In the current economic environment, the tax advantages of farmouts may not have the importance they once had.¹³⁷ Farmout agreements that cover a substantial amount of acreage have become so complex and multi-faceted that they are often preceded by a letter of intent that can take longer to negotiate and be more detailed than traditional farmout agreements.¹³⁸ Thus, if the leases have three-year primary terms and one cannot drill the prospect alone or without the participation of a partner, it is likely that one will begin to seek a farmee at the end of the first year of the lease term, given the time it will take to negotiate the farmout agreement and get everything in place to drill the earning well.

A key consideration in structuring a farmout that covers a significant amount of acreage and contemplates joint development is that the parties keep in mind that they may be entering into a long-term relationship and that things change over the course of time. For example, over time, a party's financial resources that are available to develop a project may change due to any number of facts. Furthermore, the parties may no longer see eye-to-eye on a variety of issues, such as: the pace of drilling activity; how to deal with a party who refuses to participate in development wells; whether to seek new partners to provide additional development funds; or whether to enlarge, contract, or terminate the area of mutual interest the parties have established. In drafting the farmout agreement, the parties should anticipate these conflicts and develop and provide a mechanism for dealing with them in the document.

Even with the de-emphasis of traditional farmouts in which the

135. According to Mr. O'Malley, this is Anadarko's standard policy, but Ms. Lane disagrees with it, believing that it is always useful to have the option to convert to a back-in and that tracking the payout account is not that burdensome.

136. Mr. O'Malley reports that he negotiated farmout agreements for Anadarko that provided for liquidated damages on a sliding scale if the farmee does not drill a specified number of wells—the liquidated amount is reduced each time the farmee drills a set number of wells until it no longer applies once the final threshold has been reached. The farmee is required to escrow amounts to support these obligations.

137. This is debatable. Ms. Lane believes it is generally true that tax benefits associated with farmouts have become a secondary concern, and Mr. O'Malley notes that in order to achieve the maximum benefit from the ability to currently expense IDC, the farmee must have offsetting income, which is not always the case. But Mr. Pharo believes that the loss of these tax advantages, as proposed by the current administration, would have a significant impact on the all-important cash flows at a number of companies.

138. On the other hand, Ms. Lane reports that for one-well farmouts, she has developed a two-page farmout form that works quite nicely.

farmee was in total control and the farmor was a passive observer in favor of today's "Fat Farmouts," there are still the Marvin Davis-type promoters working the oil patch (those who aggregate substantial leaseholds before a play becomes "hot," drive up bonuses, use someone else's money to develop the acreage, and retain a fat override or a 100% carry).¹³⁹ But, if they wish to land a mullet in today's economic environment with uncertain commodity prices, they had better be prepared to lower their expectations on what they will get in return.

139. See Mark Seal, *The Man Who Ate Hollywood*, VANITY FAIR, Nov. 2005, available at <http://www.vanityfair.com/politics/features/2005/11/davis200511>.