

# ANALYZING OIL AND GAS FARMOUT AGREEMENTS\*

by  
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SINCE the end of World War II, the oil and gas farmout agreement has become nearly as important and commonplace in the petroleum industry as the oil and gas lease. In part, this is a reaction to the increased risks and real costs of deeper drilling.<sup>1</sup> The phenomenon also reflects an increase in sophistication and a proliferation of small oil companies, both of which resulted from sharp increases in real prices for oil and gas in the 1970s.<sup>2</sup>

Though farmout agreements are ubiquitous in the late 1980s, practitioners and scholars have not standardized farmout agreements to the degree that they have oil and gas leases. Parties often enter into farmout agreements on the basis of informal "letter agreements." Legal writers have given relatively little attention to provisions and interpretative problems of farmout agreements.<sup>3</sup> Yet, one does not need a crystal ball to predict that farmout agreements will demand an increasing percentage of the time of oil and gas lawyers and of the courts as the years go by. The purpose of this Article, therefore, is to analyze the structure of typical agreements and consider

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1. Though the average depth of wells drilled in the United States between 1975 and 1981 remained virtually the same (4,531 feet average in 1975 versus 4,501 feet average in 1981), average drilling costs increased 155%, from an average of \$177,793 to \$453,691. See 1986 ENERGY STATISTICS SOURCEBOOK 45, 47, 49, 51, 63, 66-67, 109-10, 116-17. During that same time period, United States natural gas reserves decreased 12%, from approximately 228,000,000 MMCF to 201,500,000 MMCF, while United States oil reserves declined 10%, from approximately 32,700,000,000 barrels to 29,500,000,000 barrels. *Id.*

2. The average price of crude oil at the wellhead in the United States increased from \$3.89 per barrel in 1973 to \$31.77 in 1981. See *id.* at 295. The average price of natural gas at the wellhead increased from 21.6 cents per MCF to \$1.98 during the same period. *Id.* Partly in response, United States employment in oil and gas extraction increased from approximately 273,900 in 1973 to a peak of 708,300 in 1982. *Id.* at 395.

3. Though none are comprehensive, several excellent papers address issues of farmout agreements. See 1 L. MOSBURG, STRUCTURING EXPLORATION DEALS ch. 3 (1983); T. FAY, DRAFTING STANDARD FORM FARMOUT AGREEMENTS (A.B.A. Sec. Nat. Res. L. Monograph Series No. 1, 1986); Bledsoe, *A Detailed Look at Farmout Agreements*, ADVANCED OIL, GAS AND MINERAL LAW COURSE, 1986 TEX. OIL, GAS & MIN. L. SEC. N-1; Brown, *Assignments of Interests in Oil and Gas Leases, Farm-Out Agreements, Bottom Hole Letters, Reservations of Overrides and Oil Payments*, 5 INST. ON OIL & GAS L. & TAX'N 25 (1954); Cage, *Anatomy of A Farmout*, 21 INST. ON OIL & GAS L. & TAX'N 153 (1970); Glass, *Farmout Agreements*, WORKSHOP ON BASIC OIL AND GAS INSTRUMENTS, 1985 A.B.A. SEC. NAT. RES. L.; Himebaugh, *An Overview of Oil and Gas Contracts in the Williston Basin*, 59 N.D.L. REV. 7 (1983); Klein & Burke, *The Farmout Agreement: Its Form and Substance*, 24 ROCKY MTN. MIN. L. INST. 479 (1978); Lamb, *Farmout Agreements—Problems of Negotiation and Drafting*, 8 ROCKY MTN. MIN. L. INST. 139 (1963); Schaefer, *The Ins and Outs of Farmouts: A Practical Guide for the Landman and the Lawyer*, 32 ROCKY MTN. MIN. L. INST. 18-1 (1986); Scott, *How to Prepare an Oil and Gas Farmout Agreement*, 33 BAYLOR L. REV. 63 (1981).

some of the problems and alternatives that practitioners must confront in drafting or reviewing farmout agreements.<sup>4</sup>

Farmout agreements are important tools of a big business, and only the creativity of draftsmen and negotiators limits the options that the parties may consider. While this Article does not cover everything that one might want to know about farmouts, it does attempt to cover the basic issues that an agreement must address and to collect representative language. Even in these respects, however, the Article is not complete. In particular, many types of clauses are omitted because the author could not find examples within the time strictures of writing.

## I. WHAT IS A FARMOUT?

An oil and gas farmout agreement is an agreement by one who owns drilling rights to assign all or a portion of those rights to another in return for drilling and testing on the property.<sup>5</sup> The individual or entity that owns the lease, called the "farmor" or "farmoutor," is said to "farm out" its rights. The person or entity that receives the right to drill, referred to as the "farmee" or "farmoutee," is said to have "farmed in" to the lease or to have entered into a "farm-in agreement."

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.<sup>6</sup> Other commentators have attributed "farmout" to the term used in baseball:

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4. This Article is made possible by a grant from the Oil, Gas & Mineral Law Section of the Texas State Bar Association, and by the assistance of dozens of lawyers and landmen who responded to the author's request for suggestions and who provided more than one hundred example agreements. Those who responded included: Carol B. Arnold, Houston; David M. Arnolds, Denver; L.L. Atwell, Jr., Midland; Karen A. Berndt, Houston; Henry C. Brumley, Wichita; Wilson H. Busby, Tulsa; Lewis C. Cox, Roswell; Wayne Cummings, Dallas; Shonnie L. Daniel, Tulsa; Andrew B. Derman, Dallas; Frank Douglass, Austin; Theresa U. Fay, Dallas; Terry Noble Fiske, Denver; Douglas B. Glass, Houston; James C.T. Hardwick, Tulsa; Terry E. Hogwood, Houston; Albert D. Hoppe, Houston; Charles C. Keeble, Houston; C. Glyn King, Midland; Robert F. LeBlanc, Tulsa; Robert W. Lee, Tyler; William J. Legg, Oklahoma City; Pat Long, Amarillo; Thomas W. Lynch, Dallas; Charles F. Mansfield, Tulsa; Martha L. Marshall, Oklahoma City; Clyde O. Martz, Denver; Peter C. Maxfield, Laramie; Steven F. Meadows, Dallas; George J. Morgenthaler, Minneapolis; Joseph W. Morris, Tulsa; R. Clark Musser, Oklahoma City; Kevin McDonald Myles, Denver; Ljubomir Nacev, Tulsa; W.F. Pennebaker, Midland; James M. Piccone, Denver; David E. Pierce, Topeka; Howard F. Saunders, III, Amarillo; Hugh V. Schaefer, Denver; John R. Scott, Dallas; Richard S. Simms, Houston; Ronald T. Sponberg, Midland; Ernest E. Smith, Austin; Jeanmarie B. Tade, Houston; Anthony F. Winn, Pittsburgh; and Thur W. Young, Pittsburgh. Sample provisions quoted throughout this Article are taken from example agreements provided unless the source is otherwise identified.

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5. E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *CASES AND MATERIALS ON OIL AND GAS LAW* 624 (1986).

6. Hemingway, *The Farmout Agreement: A Story Short But Not Always Sweet*, 1 *NATURAL RESOURCES AND ENVIRONMENT* No. 2 (1985).

[I]n the oil and gas industry it has substantially the same connotation as it has in the more familiar baseball vernacular. 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. In baseball, the major league team frequently retains some kind of interest in the player, and the grantor in a farm-out transaction retains some kind of property interest in the oil and gas lease.<sup>7</sup>

Whatever the term's origin, "farmout" has become firmly entrenched in the oil and gas industry, though the courts did not use it until 1957.<sup>8</sup>

Farmout agreements must be distinguished from other commonly encountered kinds of oil and gas contracts such as operating agreements, support agreements, and seismic options. An operating agreement is an agreement between owners of the right to drill in an area that sets out the rights and duties of each in operations on the property subject to the contract.<sup>9</sup> The primary distinction between an operating agreement and a farmout agreement is functional. A farmout agreement is a contract by which one party earns an interest in an oil and gas lease owned by another, while an operating agreement is entered into to define the rights and duties of parties who already own joint interests in a lease or a drilling unit and to combine those interests for joint operations. Another distinction is that the farmee "carries" the farmor for all or a portion of the drilling costs in a farmout, while the parties to an operating agreement generally share the costs of drilling. Typically, those who enter into a farmout agreement also will execute an operating agreement to govern their rights after they have performed the farmout contract.<sup>10</sup>

A support agreement, sometimes referred to as a contribution agreement, is a contract by which one party agrees to contribute money or acreage to another party in return for geological information developed by the drilling operations of the other.<sup>11</sup> Subtypes of support agreements are typically described by reference either to the conditions upon which payment will be made or to the form of the contribution. A dry hole agreement is a support agreement in which the obligation to make payment is conditioned upon the drilling of a dry hole.<sup>12</sup> A bottom hole agreement is a support agreement that conditions the obligation to pay upon drilling to total depth and testing.<sup>13</sup> An acreage contribution agreement typically looks very much like a bottom hole agreement, except that the contribution for drilling and testing comes in the form of interests in property that the contributing party owns, rather than in money.<sup>14</sup>

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7. C. RUSSELL & R. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* ¶ 7.02 (1986).

8. Cage, *supra* note 3, at 153-54. Cage asserts that the court in *Petroleum Fin. Corp. v. Cockburn*, 241 F.2d 312, 313 n.2 (5th Cir. 1957), first used the term "farmout."

9. J. LOWE, *OIL AND GAS LAW IN A NUTSHELL* 350 (1983).

10. See *infra* notes 346-51 and accompanying text.

11. J. LOWE, *supra* note 9, at 347.

12. 8 H. WILLIAMS & C. MEYERS, *OIL & GAS LAW* 255 (1987).

13. *Id.* at 84.

14. *Id.* at 14.

Support agreements are closely related to farmout agreements, particularly farmout agreements for the purpose of exploration and evaluation. A well drilled under a support agreement is located on a lease owned by the drilling party, while under a farmout agreement a well is drilled on a lease owned by the contributing party. Timing may be the functional distinction. If the support agreement develops positive information, the party who agreed to make the contribution may follow it up by proposing a farmout. Indeed, in a variation upon an acreage contribution agreement, the contributing party will promise to farm out designated property if the drilling party will test its own lease.

A seismic option agreement may also be preliminary to a farmout agreement. A seismic option agreement is a contract in which one party agrees to conduct geophysical tests on the property of another, with the option or obligation to farm into or to buy a specified amount of acreage thereafter.<sup>15</sup> Parties often use a seismic option when they deal with large leases in unexplored areas.

Many problems are common to operating agreements, support agreements, seismic option agreements, and farmout agreements,<sup>16</sup> all of which may be described as "exploration agreements." Frequently parties make agreements that encompass more than one kind of contract and blur the distinctions made here. Nonetheless, these distinctions are helpful for analytical purposes and they reflect the practice of the oil and gas industry.

## II. THE STRUCTURE OF A FARMOUT

The interaction of two major factors determines the structure of a farmout agreement, the way that its essential terms are put together. One is the tax rules applicable. The other is the purposes of the farmor and the farmee in entering into the agreement.

### A. *The Applicable Tax Rules*

Farmout agreements are drafted with a wary eye upon the Internal Revenue Code. In fact, complicated tax rules dictate the structure of a farmout agreement. This section reviews the basic tax concepts that apply to

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15. See Vander Ploeg, *Particular Problems in the Structuring of Broad Area Exploration Contracts*, 5 E. MIN. L. INST. § 14.01 (1984); Himebaugh, *supra* note 3, at 31-32.

16. See L. MOSBURG, *supra* note 3, ch. 2 (support agreements); A. DERMAN, *JOINT OPERATING AGREEMENT: A WORKING MANUAL* (A.B.A. Sec. Nat. Res. Monograph Series No. 2, 1986) (operating agreements); Hardwick, *AAPL Model Form Operating Agreement—1982: Changes and Continuing Concerns*, 1982 ROCKY MTN. MIN. LAW SPEC. INST. ON OIL AND GAS AGREEMENTS (operating agreements); Moore, *Joint Operating Agreements—Is There Really a Standard That Can Be Relied Upon?*, 5 E. MIN. L. INST. § 15.01 (1984) (operating agreements); Vander Ploeg, *supra* note 15, § 14.01 (seismic options and support agreements); Young, *Oil and Gas Operations: Who Does What, To Whom, For Whom, and Who Pays, How, and When*, 27B ROCKY MTN. MIN. L. INST. 1651, 1652 (1982) (operating agreements); Young, *Oil and Gas Operating Agreements: Producers 88 Operating Agreements, Selected Problems and Suggested Solutions*, 20 ROCKY MTN. MIN. L. INST. 197, 198 (1975) (operating agreements).

farmouts and explains how they affect the arrangements that the parties negotiate.

### 1. *Intangible Drilling Costs*

The intangible drilling cost (IDC) deduction provides a very important incentive to the oil and gas industry. Section 263(c) of the Internal Revenue Code grants the IDC deduction.<sup>17</sup> It permits those who drill oil or gas wells to take a deduction against current income for the intangible costs of drilling and completing wells.<sup>18</sup> Intangible drilling costs are generally defined as those costs that have no salvage value in themselves and are "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas."<sup>19</sup> 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.<sup>20</sup> Intangible drilling costs typically amount to between 50% and 80% of the total costs of drilling and completing an oil or gas well. The IDC deduction makes oil and gas investments attractive to tax-oriented investors because intangible drilling costs are such a large percentage of the total costs of drilling and completing a well. The IDC deduction allows investors to drill up their profits at the end of each year.<sup>21</sup>

The IRS has limited the IDC deduction by applying what may be called the "complete payout" limitation.<sup>22</sup> Simply stated, the limitation provides

17. I.R.C. § 263(c) (West Supp. 1987).

18. *Id.* The deduction is subject to many limitations. Noncorporate taxpayers who deduct IDCs may be subject to minimum taxes and may be limited to the amounts actually at risk. See C. RUSSELL & R. BOWHAY, *supra* note 7, ¶¶ 11.01-.06, 14.19. Integrated oil companies must capitalize a portion of intangible drilling costs under I.R.C. § 291(b), (c) (West Supp. 1987), and all who claim the deduction are subject to the recapture provisions of *id.* § 1254.

19. Treas. Reg. § 1.612-4(a) (1965).

20. *Id.* For a list of typical costs incurred in the exploration and development of oil and gas and a suggested treatment of such costs for intangible drilling costs deduction purposes, see C. RUSSELL & R. BOWHAY, *supra* note 7, ¶ 14.12.

21. See C. RUSSELL & R. BOWHAY, *supra* note 7, ¶ 14.11-A. The percentage depletion provisions of I.R.C. § 613A are also important.

22. See Rev. Rul. 71-207, 1971-1 C.B. 160; Rev. Rul. 71-206, 1971-1 C.B. 105; Rev. Rul. 70-336, 1970-1 C.B. 145, *modified*, Rev. Rul. 80-109, 1980-1 C.B. 129; Rev. Rul. 69-332, 1969-1 C.B. 87. The language of the first three revenue rulings is virtually identical:

Section 263(c) of the Code, as implemented by section 1.612-4 of the Income Tax Regulations, provides an option to charge to capital or to expense the intangible drilling and development costs incurred in the drilling of oil and gas wells. This option is available only to an operator who is defined as one who holds a working or operating interest in any trace or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights. Section 1.612-4(a)(3) of the regulations, however, provides the following limitation on the option which is pertinent here:

\* \* \* except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the cost thereof which is attributable to such fractional interest is within this option. . . .

Thus, the limitation in the regulations is operative if the drilling and development project is undertaken "\* \* \* for the grant or assignment of a fraction of

that one may not claim an IDC deduction except to the extent that (1) one actually pays or accrues the expense, and (2) one will own the working interest for which the payment is made for the complete payout period.<sup>23</sup> One cannot take a tax deduction for intangible drilling costs paid for by another. For example, if a farmor and a farmee were to enter into a farmout agreement on a 50% "straight-up" basis, with the farmor contributing the farmed out lease, the farmee paying all costs of drilling and completing the well, and the farmor and the farmee sharing operating costs and profits equally, 50% of the total IDC deduction would be lost. The farmee, who actually paid 100% of the costs, could deduct only the 50% of the IDCs that it paid because it would earn only 50% of the working interest. The farmor would be entitled to no IDC deduction because the farmor paid none of the intangible drilling costs. Thus, a potential tax benefit would be lost<sup>24</sup> and the farmee would suffer a substantial increase in the cost of performing the agreement.

Because of the complete payout limitation, farmout agreements are drafted in a way that often seems strange to those who are not aware of the tax rules. The farmee earns an interest in the working interest of the drill site acreage equal to the percentage of the costs that it pays. The farmee, for example, would earn 100% working interest for paying 100% of the drilling and completion costs, 75% working interest for paying 75% of drilling and

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the operating rights \* \* \*." *The carrying party will have undertaken the drilling and development project for the entire working interest only if he holds the entire working interest throughout the complete pay-out period. If the carrying party holds the entire working interest for a period that is less than a complete pay-out period he will have undertaken the drilling and development project for the fraction of the operating rights that he receives as his "permanent" share in the mineral property.*

Rev. Rul. 70-336, 1970-1 C.B. at 145 (emphasis added). For similar language see Rev. Rul. 71-207, 1971-1 C.B. at 160 and Rev. Rul. 71-206, 1971-1 C.B. at 105.

The language quoted does not address whether an agreement would satisfy the complete payout test if the definition of payout in the farmout agreement did not require that the farmee retain the working interest until payout, but in fact the farmee did retain it. In Rev. Rul. 80-109, 1980-16 C.B. 129, *modifying* Rev. Rul. 70-336, however, the IRS concluded that the mere possibility of a premature termination of the farmee's interest was disqualifying.

23. Rev. Rul. 70-336, 1970-1 C.B. at 145; Rev. Rul. 71-206, 1970-1 C.B. at 105; Rev. Rul. 71-207, 1971-1 C.B. at 160. The language of the revenue rulings is virtually identical as to the definition of the "complete payout":

The determination of the complete pay-out period requires an interpretation of the carried interest agreement and the performance of the parties under the agreement. As a general principle, however, the period ends when the gross income attributable to all of the operating mineral interests in the well (or wells, in the case of agreements covering more than a single well) equals all expenditures for drilling and development (tangible and intangible) of such well (or wells) plus the costs of operating the well (or wells) to produce such an amount.

Rev. Rul. 71-206, 1970-1 C.B. at 105. See Rev. Rul. 70-336, 170-1 C.B. at 145-46, and Rev. Rul. 71-20, 1971-1 C.B. at 161, for similar language.

24. The farmee's tax benefit may not be irrevocably lost, because the farmee could capitalize the portion of the IDCs not deducted and recover the IDC through cost depletion over the productive life of the well. The parties likely will substantially discount a deferred tax deduction in making their deal, however, so that for practical purposes it may be considered lost. Moreover, if the farmee qualifies for percentage depletion under I.R.C. § 613A, capitalized costs effectively are lost because percentage depletion may be taken on a zero basis.

completion costs, etc. The farmor, which typically has a substantial investment in the lease, provides for a flow of income by retaining a nonoperating interest such as an overriding royalty interest. The farmor will often retain the right to "back in" to a working interest in the well site acreage after "payout," that is after the farmee has recovered all of its costs of drilling, completing, and producing the well. The IRS has accepted such transactions as qualifying the farmee to deduct the full percentage of IDC it pays so long as there is no possibility that the farmee's working interest in the drill site acreage will end before complete payout of the costs of drilling, completing, and operating.<sup>25</sup>

## 2. *Sharing Arrangements and Revenue Rule 77-176*

The IRS generally recognizes a farmout agreement as a "sharing arrangement," which it has defined as a transaction in which one party makes a contribution to the acquisition, exploration, or development of a mineral property and reserves as a consideration an interest in the property to which the contribution is made.<sup>26</sup> A sharing arrangement does not trigger recognition of income for tax purposes because the transfer of a property interest for development is treated as formation of a new economic venture, rather than as a sale of property or services.<sup>27</sup> The Internal Revenue Code contains several sections that permit sharing arrangement treatment to the formation of new businesses.<sup>28</sup> IRS administrative memoranda, rather than specific code provisions, have recognized farmouts as sharing arrangements.<sup>29</sup> The IRS

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25. See Rev. Rul. 80-109, 1980-1 C.B. 129. For an example of the strictness of the IRS position, see *infra* notes 340-43 and accompanying text. Although the logic of the revenue rulings should permit a farmee to claim a fraction of the IDCs as long as the complete payout limitation is met for that fraction, the black letter law of the revenue rulings states that the farmee must hold 100% of the operating rights until payout. See P. MAXFIELD & J. HOUGHTON, TAXATION OF MINING OPERATIONS ¶ 9.04[5][b][iii] (1987).

26. Gen. Couns. Mem. 22,730 (1941). A general counsel memorandum is an informal statement of principle for guidance of agency personnel.

27. See P. MAXFIELD & J. HOUGHTON, *supra* note 25, §§ 9.01-05.

28. See I.R.C. § 351 (West Supp. 1987) (no gain or loss recognition on exchange of property for stock of corporation); *Id.* § 721 (no gain or loss recognition to partnership or any of its partners when contribution of property is made to partnership in exchange for interest in capital and profits).

29. See *Palmer v. Bender*, 287 U.S. 551 (1933). In *Palmer* the United States Supreme Court characterized oil and gas in place as a reservoir of capital investment of the parties who agree to share in production. *Id.* at 557. The Court reasoned that parties to a pool of capital should consider transactions involving assignments of interests in oil and gas that required the assignees to assume all or part of the burden of exploitation as contributions. *Id.* at 557-58. The IRS adopted the "pool of capital" concept in Gen. Couns. Mem. 22,730 (1941). In Gen. Couns. Mem. 22,730 the IRS recognized that the drilling party under a farmout agreement could deduct the full amount of intangible drilling costs paid or incurred if that party complied with the complete payout limitation discussed above. One source interprets Gen. Couns. Mem. 22,730 to mean that acquiring an interest in a mineral property in return for services related to development of the property does not result in income either to the person performing the services or to the person receiving the services if three conditions are met:

First, . . . if the interest received is an economic interest in mineral in place for depletion purposes . . . and only if such interest is acquired for services or equipment related to exploration or development. An interest would, therefore, not qualify if it was received for services rendered after the property was devel-

reasons that the exchange of interests for development in a farmout agreement constitutes a contribution by the parties to a pool of capital. The parties to a farmout agreement therefore do not recognize income from the farmout transaction. A farmout is treated as a tax-free transfer, which has been a very important incentive to its use by the industry.

The little world of farmout agreements turned upside down in 1977 when the IRS changed the rules of the game with Revenue Ruling 77-176.<sup>30</sup> Revenue Ruling 77-176 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.<sup>31</sup> Thus, while the transfer of interest in the well site acreage in exchange for drilling remained sheltered from tax as a sharing arrangement, the IRS treated the interest in acreage outside of the well site acreage as a separate transfer subject to tax.<sup>32</sup>

oped, if it was not an economic interest in mineral in place, or if it was otherwise unrelated to development. . . .

Second, an economic interest in the mineral in place must be the agreed-upon consideration for the services or equipment in order to be received without tax. . . .

Third, the economic interest must be in the property to which the contribution is made.

A. BRUEN & W. TAYLOR, *FEDERAL TAXATION OF OIL AND GAS INVESTMENTS* ¶ 5.02, at 5-2 to -3 (1985) (footnotes omitted). The typical farmout transaction does not result in realization of income by either the farmor or the farmee because it meets these three conditions. See also Linden, *Income Realization in Mineral Sharing Transactions: The Pool of Capital Doctrine*, 31 *INST. ON OIL & GAS L. & TAX'N* 487, 508-09 (1981) (discusses income realization in typical farmout transaction).

30. Rev. Rul. 77-176, 1977-1 C.B. 77, 79. A revenue ruling is the IRS's formal statement of its position regarding a particular fact situation and the reasoning for that position. A revenue ruling is not law, but effectively warns taxpayers that failure to comply with the position taken will result in a tax assessment. See M. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶ 3.03[2][a] (1981).

31. Rev. Rul. 77-176 reasoned as follows:

Before the assignment of the working interests to X in the instant case, the oil and gas lease was, within the meaning of section 614(a) of the Code and section 1.614-1(a) of the regulations, one property in the hands of Y. Upon assignment, X received two separate economic interests in the tract or parcel of land, each such interest being a separate section 614 property [apparently because of the difference in the percentage of the working interests owned in the drill site and the surrounding acreage.] The entire working interest in the drill site to which X made a contribution in the form of drilling was one property, and the undivided one-half of the working interest in the portion of the tract exclusive of the drill site was a second property. Likewise, Y retained two separate properties in the tract or parcel of land. The overriding royalty interest reserved in the drill site was one property, and the undivided one-half of the working interest retained by Y in the balance of the tract exclusive of the drill site was a second property.

Rev. Rul. 77-176, 1977-1 C.B. 77, 79.

32. Rev. Rul. 77-176 concluded that:

Because the acreage exclusive of the drill site is a property separate from that to which the development contribution was made, drilling by X on the drill site did not represent a capital investment in the development of the acreage exclusive of the drill site, and the Federal income tax consequences of the transfer from Y to X of the undivided one-half of the working interest in such acreage is not determined under the pool of capital concept.

An example may help in understanding Revenue Ruling 77-176. Assume that *Y* owns a 640-acre lease subject to 40-acre spacing. Assume that *Y* and *X* enter into a farmout agreement by which *Y* agrees to assign to *X* 100% of the working interest in a 40-acre well site plus 50% of the working interest in the 600 acres outside the well site tract, with *Y* reserving a 1/16th overriding royalty interest in production from the well site tract and an option to convert that overriding royalty interest into a 50% working interest after payout of the initial well. Assume further that *Y*'s basis in the 50% interest in the 600 acres outside the well site earned by *X* is \$6,000, but that the market value of the 50% interest in the outside acreage when it is actually transferred is \$100,000 because the transfer occurs after the drilling of an initial well on the well site tract has proved the outside acreage.

Revenue Ruling 77-176 reasons that neither *Y* nor *X* is subject to any tax as a result of the transfer of interest or the conduct of drilling operations upon the well site acreage. Since *Y* transfers to *X* an interest in the well site in exchange for development of the well site, the transaction is a sharing arrangement. The transfer of the interest in the remaining 600 acres, however, relates to another property. The transfer of that interest does not qualify as a sharing arrangement because *X* has made no contribution to the development of the outside acreage. Drilling the well is viewed as developing only the separate property of the well site acreage. Revenue Ruling 77-176 therefore concludes that *Y* has received taxable income equal to the difference between its basis of \$6,000 in the fractional interest in the outside acreage assigned and the fair market value of \$100,000 at the time of the assignment.<sup>33</sup> *X*, on the other hand, is deemed to have received \$100,000 of taxable income, since its drilling expenditures are not a capital investment in the development of the property of the outside acreage. Both *Y* and *X* therefore have incurred a tax liability, but the transaction has generated no cash flow for either to use to pay taxes. Tax lawyers call this nightmare "phantom income."<sup>34</sup>

The IRS made application of Revenue Ruling 77-176 prospective only.<sup>35</sup> In addition, commentators have criticized its reasoning and a successful challenge may yet be forthcoming.<sup>36</sup> Nonetheless, the ruling is a major tax

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*Id.* at 79-80.

33. *Y* may be subject to tax at ordinary or capital gains rates depending upon whether the transaction occurred before or after the effective date of the Tax Reform Act of 1986 provisions relating to capital gains and whether *Y* is considered a "dealer." Cf. *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S.46 (1955) (corn futures not capital assets since integral part of taxpayer's manufacturing business).

34. See D. WINDISH, *TAX-ADVANTAGED INVESTMENTS* ch. 16 (2d ed. 1985).

35. The revenue ruling specifically states that it will apply retroactively "to transfers made before April 27, 1977, or to transfers made pursuant to binding contracts entered into before such date." Rev. Rul. 77-176, 1977-1 C.B. at 79-80. In addition, the IRS issued a technical advice memorandum indicating that it would not apply related theories reaching the same result to pre-April 27, 1977, transactions. See Tech. Adv. Mem. 83-11-005 (Nov. 19, 1982).

36. See Crichton & Griffin, *Securities Problems and Tax Implications of Oil and Gas Investments by Non-Industry Financiers*, 27B ROCKY MTN. MIN. L. INST. 1333, 1392-97 (1982); Gregg, *Oil and Gas Farmouts—Implications of Revenue Ruling 77-176*, 29 INST. ON OIL & GAS L. & TAX'N 601 (1978); Note, *New Tax Treatment of Oil and Gas Farm-Outs: A Threat to Domestic Production*, 15 HOUS. L. REV. 387 (1978). Most of the criticisms of the reasoning

trap for the oil and gas industry, and a variety of devices have been suggested to avoid or minimize it.<sup>37</sup> Among the most popular suggestions are (a) avoiding the transfer of an interest in "outside" acreage; (b) structuring the farmout to minimize the value of outside acreage transferred; and (c) redefining the "property" subject to the farmout by use of a tax partnership.

*a. Assign No Outside Acreage*

*Y* and *X* can avoid Revenue Ruling 77-176 entirely if the farmout transfers no interest in any acreage outside the well site tract. Then there is only a single transaction relating to a single property, and the sharing arrangement concept protects both *Y* and *X* from recognizing income. No tax is due if *Y* and *X* agree that *X* will earn 100% of the working interest in a 40-acre drill site tract in exchange for drilling a well on a 640-acre lease, subject to a 1/16th overriding royalty interest reserved to *Y* that *Y* can convert upon payout of the well to a 50% working interest in the well site tract.

The problem with this transaction lies with its economic structure, not its tax structure. Limiting the interest earned to the well site tract strips from the farmout much of the incentive for *X*. There is a severe limit on the profit opportunity for *X* if the farmout's purpose is to explore undeveloped leases. A farmee will not easily decide to take 100% of the risk of drilling a wildcat well<sup>38</sup> in return for a 50% interest in the well subject to an overriding royalty burden and no interest in development wells. In order to make the business deal workable between *Y* and *X*, *Y* will probably have to provide *X* with additional incentives. For example, *Y* may have to accept a lower overriding royalty and agree to accept a lesser percentage back-in, or even give up the back-in altogether. These possibilities may make the transaction less attractive to *Y*, and yet still be insufficient to satisfy *X*. Thus, while the parties can easily avoid the tax consequences of Revenue Ruling 77-176, the economic cost may be unacceptable.

A less certain variation on the theme of avoiding Revenue Ruling 77-176 by transferring no interest in outside acreage is for *Y* to agree to assign to *X* 100% of the working interest in the entire 640 acres in return for drilling a well on the 40-acre drill site tract. The 640-acre assignment from *Y* to *X* may be subject to a 1/16th overriding royalty, which *X* can convert upon

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of Rev. Rul. 77-176 center upon application of § 614 of the Internal Revenue Code. Note, *supra*, at 388-414. The revenue ruling describes interests transferred in the drill site and in acreage outside the drill site, which are parts of the same lease, as separate property within the meaning of § 614(a) of the Code. Rev. Rul. 77-176, 1977-1 C.B. 77, 79. A strong argument to the contrary is that since both interests were working interests in the same lease they should be treated as interests in a single property under § 614(b). Only one reported case, *Burke v. Blumenthal*, 504 F. Supp. 35 (N.D. Tex. 1980), to date has challenged the validity of Rev. Rul. 77-176. In *Burke* the plaintiff sued for declaratory injunctive relief arguing that the revenue ruling appeared "unconstitutional, unlawful, null and void" because it erroneously interpreted §§ 61 and 1001(a) of the Internal Revenue Code. *Burke*, 504 F. Supp. at 37 n.1. The federal district court dismissed the case on the grounds that the court lacked subject matter jurisdiction. *Id.* at 36.

37. See *infra* text accompanying notes 38-59.

38. 8 H. WILLIAMS & C. MEYERS, *supra* note 12, at 974.

payout as to the well site acreage, or at any time as to the outside acreage. Thus, while *X* will own the entire working interest in the entire 640-acre tract, if *X* decides to drill an additional well on the property, *Y* will be able to convert its interest in the additional acreage and participate in drilling as a working interest owner.

This device is less certain to avoid taxation than the first alternative. While the form of a transaction that avoids the transfer of an interest in an outside acreage is maintained, the substance is not.<sup>39</sup> It is highly probable that the initial well drilled on the property will drain no more than the 40-acre drilling unit established. That is the purpose of the state in establishing the drilling unit. If so, *X*'s contribution to drilling will develop only the well site acreage and *X* will receive an extra interest in outside acreage. *Y*'s right to convert its overriding royalty interest in the outside acreage will add fuel to the fire of the argument that the substance of the transaction is the same as that considered in Revenue Ruling 77-176. Thus, the IRS may regard the outside acreage as a separate property under Revenue Ruling 77-176 and assess tax on that acreage. Since the market value of *X*'s 100% working interest in the outside acreage subject to *Y*'s right to convert will be roughly the same as the value of *X*'s interest after the conversion has taken place, the tax liability should be approximately the same as if the parties had not selected the illusory form.

A final variation of avoiding Revenue Ruling 77-176 by assigning no outside acreage in the farmout agreement is to make the farmee's earning an interest in the well site acreage contingent upon performance by drilling, but to give the farmee a noncontingent option to acquire additional interests in the outside acreage at an agreed price.<sup>40</sup> The farmout transaction is split into two parts. In one the farmee earns by drilling. In the other, a supposedly unrelated transaction, the farmee buys an option to drill additional wells at a fixed price. If the farmor may terminate the option if the farmee fails to drill the initial well, however, this device may be attacked as a sham, or IRC section 83 may cause the surrounding acreage to be valued and taxed to the farmee after the well is drilled.<sup>41</sup> In addition, the purchase option must be at fair market value, or the farmee as well as the farmor may be

39. That substance prevails over form in taxation matters is well-established. See *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935); *West v. Commissioner*, 150 F.2d 723, 727 (5th Cir.), *cert. denied*, 326 U.S. 795 (1945).

40. The following example illustrates a noncontingent option to purchase an interest in outside acreage:

Farmee, upon execution of this agreement, shall be entitled to purchase an undivided \_\_\_% of Farmor's interest in the \_\_\_ 1/4 of Section \_\_, Township \_\_, Range \_\_, \_\_ County, \_\_, limited to the depth stated above and without warranty of title express or implied. Farmee shall pay Farmor for such interest at a rate of \$\_\_ per net mineral acre, proportionately reduced. Such payment shall be made no later than \_\_ from the date of Farmee's execution hereof.

41. I.R.C. § 83 (Supp. III 1985), provides in part:

If, in connection with performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property . . . at the first time the rights

required to recognize income.<sup>42</sup>

*b. Minimize the Value for Revenue Rule 77-176 Purposes*

Another general approach to Revenue Ruling 77-176 structures the farmout agreement between *Y* and *X* so that, while the revenue ruling may still trigger the adverse tax effect, its impact will be minimized. A present assignment, an assignment of the working interest in acreage outside the well site contemporaneous with execution of the farmout agreement, is one method. Another method is to structure the agreement so that the farmee earns a restricted drilling option, rather than a portion of the working interest in the outside acreage.

*i. Present Assignment*

If *Y* assigns its interest to *X* at the time that they enter the farmout agreement, rather than after the earning well has been drilled, the tax effect should be less burdensome for both *Y* and *X* because the value of the interest in the outside acreage will be less. Suppose that in the hypothetical situation discussed above<sup>43</sup> *Y* assigned *X* 100% of the working interest in the well site acreage and an undivided 50% of the working interest in the additional acreage at the time that they executed the farmout agreement. By the logic of Revenue Ruling 77-176, the value of the additional property transferred should be determined as of the time the contract was executed.<sup>44</sup> Furthermore, the value should be substantially less since the drilling of the earning well has not yet proved the outside acreage. For example, assume that in the hypothetical situation above, the parties agreed to a present assignment of half the working interest in the acreage outside the well site tract at the time that they executed the farmout agreement, and that the fair market value of that interest at the time of assignment was \$10,000. Revenue Ruling 77-176 would cause both *Y* and *X* to recognize income for tax purposes, but *Y*'s taxable income would be the difference between the fair market value of

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. . . are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights . . . are transferable or not subject to a substantial risk of forfeiture, whichever is applicable.

*Id.* One commentator has argued that Congress did not intend § 83 to apply to farmout transactions. Linden, *supra* note 29, at 531-33. The IRS, however, has given some indication that it does not agree. See Lofgren, *Eccentric Orbits—A Tax Overview of Oil and Gas Transactions*, 7 E. MIN. LAW INST. 12-1, 12-25 to -27 (1986).

42. The transaction, structured as a separate sale of the option to drill on the outside acreage, is subject to tax. I.R.C. § 83 (Supp. III 1985). If the farmee pays a fair price for the option, it recognizes no taxable income. *Id.* Whether or not the option price is fair, the farmor receives taxable income to the extent that the value of the option exceeds its allocated basis.

43. See *supra* text accompanying notes 30-34.

44. Rev. Rul. 77-176 reasons that *Y* and *X*'s taxable income is determined by the fair market value of the interest transferred in the acreage outside the well site at the time of the transfer, because that is when the transaction is consummated. Rev. Rul. 77-176, 1977-1 C.B. 77, 79-80. If the transfer takes place at the time of the execution of the farmout agreement, the value should logically be set at that time.

\$10,000 and *Y*'s \$6,000 basis. *X*'s income would be \$10,000, rather than \$100,000. Both *Y* and *X* would receive phantom income, but at levels with which they probably could cope.<sup>45</sup>

Present assignment presents both practical and theoretical difficulties, however. The major practical problem is what *Y* can do if *X* does not drill the well. By its present assignment, *Y* has given up the control provided by withholding the assignment of interest until after performance. Unfortunately, neither of the commonly encountered solutions is entirely satisfactory. One solution is to draft the agreement so that the interest assigned to *X* is regained by *Y* if *X* does not drill the earning well. Providing in the farmout agreement for the reassignment of the interest by *X* may accomplish this result. If *X* is unable or unwilling to drill the earning well, however, *X* may likewise be unable or unwilling to make the reassignment. This problem can be overcome by (1) placing a fully executed reassignment in escrow at the time that the farmout is executed, (2) by drafting the present assignment in the form of a sublease that automatically terminates if the farmee does not perform,<sup>46</sup> or (3) drafting the present assignment in a nonrecordable form and simply refusing to provide the farmee with a recordable assignment until the farmee has performed. Whether these convoluted structures will stand up under the IRS's scrutiny, however, is a matter for concern. Only a property lawyer is likely to view as significant the difference

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45. The present assignment also appears attractive because it should avoid the never-resolved tax issue of whether transfer of an interest in acreage outside the well site after completion of an earning well under a farmout agreement is transfer of a "proven" property within I.R.C. § 613A(c)(9) (West Supp. 1987) so that percentage depletion is unavailable to the farmee. If the transfer of interest takes place before the drilling of the earning well, the property almost certainly cannot be proven.

46. The following example illustrates a sublease that terminates automatically upon a farmee's failure to perform:

Farmor hereby subleases and assigns to farmee, its successors and assigns, for the term hereinafter specified, the following rights in the farmout leases:

- (1) All of Farmor's right, title and interest in the Farmout Leases insofar as the Farmout Leases cover lands lying within the Drilling and Spacing Unit within which the Earning Well is located; and
- (2) an undivided \_\_\_% of Farmor's right, title and interest in the Farmout Leases insofar as the Farmout Leases cover the balance of the Farmout Lands;

subject, however, to the reservation to Farmor, its successors and assigns, of Farmor's Reserved Interest [provided for elsewhere in the agreement], and of all other interests in the Farmout Leases and Farmout Lands not expressly subleased and assigned to farmee.

This sublease and assignment will remain in effect until the Commencement Date [of drilling operations], and so long thereafter as Farmee shall remain in compliance with the Earning Conditions. Upon satisfaction by Farmee of the Earning Conditions, this sublease and assignment shall remain in effect for so long as any of the Farmout Leases, or any extensions or renewals thereof, remain in effect as to any portion of the Farmout Lands; provided that, upon completion of the Earning Well, this sublease and assignment shall terminate insofar as the Farmout Leases cover depths below the Farmout Depth.

Upon the expiration of the term of this sublease and assignment, all rights in the Farmout Leases shall revert to Farmor, its successors and assigns, free and clear of all liens, encumbrances, burdens or obligations created by or through Farmee, its successors or assigns.

L. MOSBURG, PROBLEMS AND PITFALLS IN EXPLORATION AGREEMENTS 218-20 (1982).

between an interest that is vested in the farmee subject to defeasance if the farmee does not perform and one that is contingent upon drilling the earning well.

A risk also exists that IRC section 83 will apply to unravel the purpose of the assignment. Section 83 provides that an interest subject to a "substantial risk of forfeiture" is to be valued at the time that that substantial risk no longer applies, rather than when the interest is received.<sup>47</sup> When the interest assigned to the farmee is subject to reassignment, perfection by recording, or reverter, section 83 arguably will defer valuation of that interest in the outside acreage until (and if) the farmee actually fulfills its obligation, and the outside acreage is no longer subject to a risk of forfeiture.<sup>48</sup>

A second possible solution is for the farmer to forgo the right to obtain back the interest conveyed to the farmee, and instead to couple the present assignment with the farmee's covenant to drill the earning well secured by a liquidated damages provision<sup>49</sup> and a performance bond or other security.<sup>50</sup> While this solution will work in theory, it is likely to prove very difficult to negotiate or to put into effect.

## ii. Assign Continuous Restricted Options

Another way to minimize the effect of Revenue Ruling 77-176 is to structure the farmout agreement so that *X* earns no working interest in acreage other than the drill site, but acquires successive options to drill additional wells on the outside acreage. For example, the farmout agreement may provide that *X*, by drilling the initial well, earns a nonassignable option to drill an additional well at a location of its choice on the outside acreage within three months of completion of the earning well. Exercise of the option may earn another option, and so forth.<sup>51</sup> As an alternative, the parties may draft the agreement so that the farmee earns an interest in the outside acreage by drilling an initial well in the drill site, but an interest that automatically

47. See *supra* note 41.

48. Larason, *How to Structure the Farmout and Avoid Its Pitfalls*, in *MATERIALS ON OIL AND GAS CONTRACTS* 127-28 (J. Lowe ed. 1986).

49. For a discussion of liquidated damages provisions, see *infra* text accompanying notes 239-41.

50. For an example of a performance bond clause, see *infra* note 242.

51. See, e.g., *Energy Reserves Group v. Tarina Oil Co.*, 664 S.W.2d 169 (Tex. App.—San Antonio 1983, no writ), in which the farmout provided that:

You agree that in the event we timely commence the re-entry operations upon the C-1 well, we shall have an option for a period of one-hundred twenty (120) days from the date said well is recompleted as a producer of oil or gas . . . to re-enter the Cooke B-1 well located on the lands described under lease No. 1 above and to re-work said well . . . .

In the event we have timely commenced re-entry operations upon the B-1 well, you grant to us an option for a period of one-hundred twenty (120) days from the date we either recomplete said well as a producer of oil or gas or abandon same as a dry hole, to re-enter the Cooke A-1 well located on the lands covered by leases Nos. 2 through 5 as listed above, . . . .

*Id.* at 174. For a discussion of "completion" and similar terms, see *infra* text accompanying notes 189-95.

terminates unless continuous drilling occurs.<sup>52</sup> Assigning continuous restricted options may avoid Revenue Ruling 77-176, since it is not within the ruling's literal terms. More likely, however, this structure will merely minimize the value of the outside interest earned. A restricted option possesses some minimal fair market value, but it is minimal, at least until several successful exercises of the option greatly increase the value of the remaining acreage subject to the successive options.

Again, however, the attempt to frame the farmout agreement to avoid or minimize Revenue Ruling 77-176 has a price that *Y* and *X* may not wish to pay. The restricted option minimizes the effect of Revenue Ruling 77-176 because the economic value of a restricted option is substantially less than the economic value of an unrestricted working interest in the outside acreage. Both *Y* and *X* will take the economic truth into account in their dealings. All other things being equal, *X* will find it less attractive to enter into a farmout agreement with *Y* in which *X* takes the risk of drilling to earn a restricted option to drill rather than an unrestricted working interest. The result appears to be that either properties that would have been drilled before the promulgation of Revenue Ruling 77-176 will not be drilled, or *Y* will have to give other incentives to induce *X* to enter into the agreement.

### c. *The Tax Partnership*

The most popular device to avoid Revenue Ruling 77-176 is the tax partnership. By forming a partnership for tax purposes, but not for state property law purposes because that would expose them to joint and several liability,<sup>53</sup> *Y* and *X* can circumvent the revenue ruling's conclusion that the outside acreage earned by *X* is a separate property.<sup>54</sup> This is done by using IRC section 721—the same section of the tax code that categorizes contribu-

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52. For example:

If the test well is completed as a well capable of producing oil and/or gas in paying quantities, then, unless Farmoutee shall commence another well within one hundred twenty (120) days after completion of the test well, there shall be effective as of the date hereof, an automatic reversion to Assignor of the interest hereby assigned to all acreage in the farmout area that is not included in a governmentally prescribed proration or drilling and spacing unit for the test well.

Subsequent wells must also be commenced within one hundred twenty (120) days after completion of the preceding well. All such wells shall be drilled to a depth sufficient to test the same intervals or formations productive in the test well in which commercial production is established. Cumulative credit shall be given for faster drilling. Farmoutee shall not be required to drill any additional wells, but when Farmoutee fails to commence any well within the prescribed period, there shall be an automatic reversion to Assignor of the interest hereby assigned, effective as of the date hereof, except as to each tract (as described above) upon which there is located a well capable of producing oil or gas in paying quantities.

53. See *infra* text accompanying notes 406-33.

54. For a definitive discussion of tax partnerships, see Gregg, *supra* note 36, at 627-39. Mr. Gregg, however, concludes that a formal partnership is the safest way around Rev. Rul. 77-176. Gregg, *supra* note 36, at 632; see also Priestly, *Tax Partnerships in the Oil and Gas Industry*, THE LANDMAN, June 1983, at 9 (discusses formal tax partnerships); Wegher, *Taxation of Earned Interests—The Impact of Revenue Ruling 77-176*, 24 ROCKY MTN. MIN. L. INST. 521 (1978) (discusses tax partnerships).

tions to the capital of a partnership as a nontaxable sharing arrangement—to designate both the well site acreage and the additional acreage as the “property” of the tax partnership.<sup>55</sup> The parties accomplish this designation by using a typical farmout agreement with the special provision that the parties agree not to elect out of Subchapter K of the Internal Revenue Code<sup>56</sup> and agree to allocate income and deductions specially on a partnership return.<sup>57</sup> The economics of the farmout arrangement remain virtually the same as before Revenue Ruling 77-176; only the form is different.

To the nontax lawyer, a tax partnership may sound like a classic example of form over substance, but it appears that the IRS has tacitly accepted its effect. Shelter from the ravages of the revenue ruling is not without cost, however. In order to establish a valid tax partnership, a partnership return must be prepared and filed annually, so long as the partnership is in existence.<sup>58</sup> Preparation of the partnership return requires substantial expenditures for legal, accounting, and administrative support that many companies begrudge. Furthermore, some are concerned that regulations recently issued under IRC section 704(b) will interact with section 613A and section 704(c) to undermine the economic attractiveness of a farmout where a tax partnership is used.<sup>59</sup>

#### d. Conclusion

Revenue Ruling 77-176 provides a classic example of bad tax policy. It has not raised substantial revenues. Indeed, it has probably cost the government taxes, because the major oil companies that are the focus of IRS compliance audits are well aware of its requirements. They have hired the necessary lawyers, accountants, and administrative personnel to analyze farmout proposals for Revenue Ruling 77-176 implications and to prepare the documents necessary to minimize or avoid it. As a result, major oil com-

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55. I.R.C. § 721 (1982 & Supp. III 1985).

56. The following provision is from a tax partnership agreement attached to a farmout agreement:

1. Notwithstanding any provisions of the above referred to Farmout Agreement or Operating Agreement to the contrary, the parties hereto have agreed not to elect to be excluded from the application of Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code of 1954 and all amendments thereto (hereinafter called the “IRC”) and similar provisions of the State Income Tax Law. The parties further agree to the provisions hereof regarding the reporting of income, gains, losses, expenses, costs, and credits for Federal and State income tax purposes.

57. Taxpayers may allocate profits and losses without recognition of income, so long as these profits and losses cannot be valued immediately. *Diamond v. Commissioner*, 492 F.2d 286, 288-91 (7th Cir. 1974). A transfer of property, however, could result in income under Treas. Reg. § 1.721-1 (1956).

58. I.R.C. § 6031 (Supp. III 1985). Some lawyers and accountants that I have talked with believe that the partners can terminate a tax partnership in the tax year following its creation. Others are concerned that quick termination may throw into question the “substantial economic effect” required to make the tax partnership work in the first place. See Treas. Reg. § 1.704-1(b)(2) (as amended 1985).

59. See Lofgren, *supra* note 41, at 12-27; see also Houghton, Braden & Harris, *Housing Your Mineral Activities in the Right Structure*, 31 ROCKY MTN. MIN. L. INST. 6-01, 6-03 to -04 (1985) (discusses substantial economic effect of operation of tax partnerships).

panies rarely violate the tenets of the ruling. In addition, they deduct the cost of the lawyers, accountants, administrative staff, and support facilities that they rely upon for compliance. Of course, the IRS must pay for the auditors and support facilities that it needs to audit for Revenue Ruling 77-176 compliance, as well. Though no figures are available, it is a fair bet that Revenue Ruling 77-176 has resulted in a net loss of tax dollars when compliance and auditing costs are considered.

In addition, the IRS seemingly chooses to enforce the ruling selectively. Substantial numbers of tax assessments would result if the IRS would audit the little players, the thousands of "ma and pa" oil companies that have never heard of Revenue Ruling 77-176 to say nothing of the devices to avoid it. Such audits have not taken place, however, probably because the IRS has concluded that it would be politically unpopular and would throw many companies into bankruptcy while raising little revenue.

In short, Revenue Ruling 77-176 should embarrass tax policy makers. As long as the ruling remains IRS policy, however, there is a major tax trap for the unwary in farmout transactions.

### *B. The Purposes of the Parties*

Any one or a combination of several factors may motivate the parties to a farmout agreement. Because the goals of the parties profoundly affect the structure of the agreement, a brief consideration of the parties' purposes is worthwhile.

#### *1. The Farmor's Purposes in Entering an Agreement*

The management of an entity that owns an oil and gas lease may wish to farm out that lease for a variety of reasons. Any list of reasons must include (a) lease preservation, (b) lease salvage, (c) risk sharing, (d) exploration and evaluation, (e) access to market, (f) obtaining reserves, and (g) drilling an "obligation" well. In each case, the farmor gives up a portion of its interest in its lease or leases to another to further what it regards as its own interests.

##### *a. Lease Preservation*

Oil and gas leases are typically drafted to expire at the end of a primary term,<sup>60</sup> and oil companies frequently find themselves holding leases that they evaluate as good risks, but that they cannot test or develop within their primary terms. The inability to act may result from cash or credit shortages, inadequate number or skills of personnel, corporate reorganizations, or even managerial inefficiency. Whatever the precise reason, the lessee's rights under a typical oil and gas lease terminate automatically and completely at the end of the primary term unless the lessee or an assignee is conducting drilling operations. Automatic termination wipes out in an instant all of the

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60. The lease primary term is an option period, during which the lessee can hold the leased property without obligation to drill. See E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 127.

money that the lessee may have spent acquiring and evaluating the prospect, and ends the lessee's prospects of developing the resources covered by the lease. Though far more oil and gas leases terminate at the end of their primary terms than are drilled, lease termination is an anathema to oil companies. Drilling is considered the natural order of things both by potential farmors and potential farmees. A primary motivation of farmors in entering into farmout agreements, therefore, is to prevent lease termination.

When lease preservation is a strong motivation, one may expect relatively liberal farmout terms. The object of the contract is to entice the farmee to drill. The farmor's main goal is not achieved if that is not done. Thus, while drilling may be an obligation of the farmee, and completion of a well capable of production is certain to be a requirement,<sup>61</sup> testing requirements are likely to be minimal, and the percentage of interest earned and the acreage earned by the well are likely to be high, though the farmor will try to retain deep rights.

*b. Lease Salvage*

Far more frequently than farmors admit, their motivation to farm out is to try to salvage something of value from a lease that the farmor's geologists and geophysicists evaluate as a poor prospect. As one correspondent wrote me, "We are liberal with farmouts because our goal is to get anything done on an area we have condemned. If something is found, we are that much better off." While this motivation may seem at first blush to be akin to P.T. Barnum's "bigger fool" theory, oil and gas exploration is such an uncertain science that the farmor's specialists are as likely to be wrong as to be right. The farmee is free to draw its own conclusions as to whether and how to proceed. When the farmee suspects that the farmor may be seeking to salvage its lease, the agreement should provide that the farmor make its geologic and geophysical information and evaluations available and, if drilling is an obligation, that the farmee will have a reasonable period of time after receiving the information to withdraw from the agreement.<sup>62</sup>

A salvage motivation is closely related to a lease preservation motivation. The distinction is that when lease preservation is the motivation, the farmor would drill if it could, while when salvage is the motivation, the farmor has decided that it does not wish to drill. Both motivations are similar, however, in that the farmor hopes to end up with an interest in production without spending any more money. Where the farmor's purpose in farming out is to salvage its lease, the terms of the farmout will be similar to those found when its goal is lease preservation, but may be even more liberal. The farmor's focus is likely to be the size of its retained interest. In addition, drilling is

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61. To maintain the lease in its secondary term, a well capable of producing in paying quantities must exist, even if the lease savings provisions are to be relied upon to preserve it. *See id.* at 171-80, 187-98. Thus, a "drill to earn" farmout serves little purpose if lease preservation is the primary goal.

62. For a discussion of farmout clauses requiring the sharing of geological and geophysical information, see *infra* text accompanying notes 163-64.

likely to be an option rather than an obligation, because the farmor has relatively little to lose if the farmed-out property is not drilled.

*c. Risk Sharing*

Modern oil and gas wells are tremendously expensive to drill in comparison to wells drilled in the earlier years of the United States oil and gas industry.<sup>63</sup> When confronted with drilling costs that may reach tens of millions of dollars, few companies are so big that risk sharing is not an attractive option. While a lessee may prefer a sale of a portion of its lease coupled with a joint operating agreement, because it permits the lessee to remain in control of operations, the lessee may also consider farming out, particularly if the proposed farmee is considered to be a good operator. Where the farmor's primary purpose in farming out is risk-sharing, the parties may structure the farmout agreement much like a joint operating agreement: drilling will be an obligation rather than an option, the farmee will earn its interest merely by drilling, the farmor may share a part of the costs, and the farmout may cover multiple wells.

*d. Exploration and Evaluation*

Sometimes the goal of a farmor's management in farming out is to obtain geological information from its leases so that it can evaluate other leases that it holds in the same area. Although the farmor in this situation hopes that the farmee's operations will yield production, the farmor's primary purpose in entering the agreement is similar to its purpose in entering into an acreage contribution agreement. The farmor wants the information that drilling operations will produce, whether or not drilling operations locate hydrocarbons.

When the farmor's primary purpose in farming out is to develop exploratory information, the contract will emphasize the tests to be conducted in the course of drilling, the formations to be tested, and the depth to be drilled. The number and complexity of the tests that they require typically distinguish exploratory farmouts from other kinds of farmouts. Exploratory farmouts are also likely to contain area of mutual interest clauses,<sup>64</sup> which obligate the farmor and the farmee to share leases on properties that may look attractive as a result of the exploratory drilling. Whether drilling is an option or an obligation, whether the farmee will earn by completing a well capable of production or merely by drilling to a specified depth and testing, and what percentage interest will be earned in what acreage are all matters that will depend upon the bargaining leverage of the parties.

*e. Access to Market*

A lessee is unlikely to drill even good geologic prospects if it lacks access to market. Though there is always a market for oil, logistical problems such

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63. See *supra* note 1.

64. See *infra* text accompanying notes 372-77.

as lack of manpower or transport in the area may make marketing impractical. When there is a surplus of natural gas, an operator may find it impossible to locate a buyer at any reasonable price. Thus, another possible motivation for a lessee to farm out leases is to acquire access to markets for the production anticipated from drilling. Giving an interest to an operator that has the capability to market may be the best deal available to a farmor.

When access to market is the farmor's motivation to offer the farmout, the parties will probably structure the agreement much like an agreement motivated by lease preservation. Terms are likely to be liberal, testing requirements are likely to be minimal, and production to earn will be required. The farmor will insist, however, upon placing the burden of marketing upon the farmee. The farmor will either retain an overriding royalty convertible at its option<sup>65</sup> or require the farmee to agree to market the farmor's share of production on the same terms and conditions that the farmee obtains for itself.

*f. Obtaining Reserves*

Yet another motivation for one who owns a lease to farmout is to obtain commitment of the reserves that may be discovered by drilling on the lease. Obtaining reserves is a common motivation for pipelines to farm out leases they hold, particularly in times of gas shortages. Pipelines have a legal obligation to make gas available to their customers. Their primary business is transporting and selling gas, not exploration and production. Therefore, pipelines often build up inventories of oil and gas leases with the intention of farming them out to producers who will drill on them and sell the gas back. Refining companies may follow a similar procedure. Pipelines and refiners sometimes establish their own exploration subsidiaries.

When obtaining reserves is the farmor's motivation, the key provision in the farmout agreement will be a "call" on production by the farmor or a commitment to a gas contract.<sup>66</sup> The farmor will prefer a firm commitment to drill from the farmee, and if the farmor has the bargaining leverage, it may impose onerous testing requirements that will help it evaluate other leases that it may hold in the area. Commonly, however, the terms of a farmout agreement motivated by obtaining reserves will be very liberal except for the call or commitment provisions.

*g. To Drill an "Obligation" Well*

While oil and gas leases typically impose no express obligation upon the lessee to drill wells, drilling may be an implied obligation. Even during the primary lease term, the courts require the lessee to protect against drainage, if the lessee can do so profitably.<sup>67</sup> When the lease is being held by produc-

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65. See *infra* text accompanying notes 301-14.

66. See *infra* text accompanying notes 399-405.

67. In most states, this is true even though the lessor has accepted delay rental payments. Rentals waive the covenant to test, but not to protect against drainage. *Texas Co. v. Ram-sower*, 7 S.W.2d 872, 875-77 (Tex. Comm'n App. 1928, judgment aff'd). *But see, e.g., Clear Creek Oil & Gas Co. v. Bushmaier*, 161 Ark. 26, 255 S.W. 37, 38-39 (1923) (lessor not entitled to recover damages for lessee's failure to explore and develop gas wells on leased premises

tion, and a reasonable, prudent operator would drill additional wells or explore further, the law implies an obligation upon the lessee to protect the interests of the lessor.<sup>68</sup> When the appropriate means of protection, development or exploration is to drill, the industry refers to the drilling of an "obligation well."<sup>69</sup>

The hallmark of an obligation well farmout is that the farmee will have a binding legal obligation to drill on the farmed-out acreage. Since the farmor's primary purpose in farming out is to relieve itself of legal liability to its lessor, an obligation to drill is essential. All other issues are negotiable.

## 2. *The Farmee's Purposes in Entering into a Farmout*

The farmee's purposes in entering into a farmout agreement often mirror the motivations of the farmor. The farmee may be interested in entering into a farmout because (1) the farmout is the quickest or cheapest way to obtain or expand an acreage position or to obtain reserves; (2) the farmee may have cash, or equipment and personnel that it wishes to keep busy; (3) the farmee may highly evaluate a property that the farmor has dismissed as a poor prospect; or (4) the farmee may want to become active in an area, but be unwilling or unable to take the risks alone.

In addition, a farmee may be interested in a farmout proposal simply because it is available. Oil company landmen are inveterate deal makers. It is not uncommon to find a particular company involved in substantial numbers of farmouts both as a farmor and as a farmee without any clear-cut pattern to the trades.

### III. PREPARING AND ANALYZING THE FARMOUT AGREEMENT

The process of preparing a farmout agreement or analyzing a proposed or disputed agreement is very much the same. In each case, the drafter must scrutinize the essential provisions of the instrument both separately and in their relationship to the structure of the agreement. This section of this Article considers that process in relation to preliminary or background matters, the key characteristics of the farmout agreement, and issues that must be addressed.

#### A. *Preliminary Matters*

##### 1. *Reputation and Solvency*

Some deals should not be made. The best drafted contract cannot fully

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when lessor accepted payments of annual rentals under oil and gas lease providing that payment thereof in lieu of drilling well should continue lease).

68. In Texas and Oklahoma, apparently no implied obligation to explore further exists separate from the implied covenant to develop. *But see* Sun Exploration & Prod. Co. v. Jackson, 715 S.W.2d 199, 201-03 (Tex. App.—Houston [1st Dist.] 1986, writ granted) (lessee may be obligated to conduct further development operations on leased premises if further exploration would be beneficial to both lessee and lessor). For discussion of the issue and its significance see J. LOWE, *supra* note 9, at 292.

69. See 8 H. WILLIAMS & C. MEYERS, *supra* note 12, at 563.

protect a party from another who is a knave or a fool. The farmor and the farmee must both confront the possibility of substantial losses if the farmout transaction proves unsuccessful. People in the oil industry sometimes forget this basic principle, particularly in the press of an attempt to maintain a lease about to expire. A review of a farmout agreement should begin by asking questions about the reputation and solvency of the proposed business partner.

## 2. Reasonableness of the Proposal

The second step in the review of a farmout proposal or agreement should be to consider what is reasonable for the parties to agree to do, given the circumstances of time and economics. How long until the leases to be farmed out will expire? Are drilling rigs readily available? How likely is it that title curative will be required?<sup>70</sup> Will it be necessary to obtain conservation orders<sup>71</sup> or to comply with special conservation rules?<sup>72</sup> A transaction that cannot be consummated is not a good business deal.

## 3. Preliminary Negotiations

Parties often negotiate farmout agreements through an exchange of letters. Disputes may arise over whether the parties have formed a binding contract, or whether they have merely engaged in preliminary negotiations.<sup>73</sup> *Smith v. Sabine Royalty Corp.*<sup>74</sup> illustrates the problem. In *Sabine Royalty Corp.* Sabine, a fractional mineral interest owner, wrote Smith, another mineral interest owner who had expressed an interest in acquiring the right to drill, proposing terms under which it "would be willing" to lease to Sabine's subsidiary, which in turn would farm out to Smith.<sup>75</sup> The letter concluded: "If you wish to pursue this arrangement, please let us know and the appropriate instruments will be forwarded for your review."<sup>76</sup> Without

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70. The farmout agreement should entitle the farmee to all of the farmor's title information. Often, the farmout agreement specifically provides for this right. See *infra* note 161 for an example of language that provides for title information to be delivered to the farmee. As a practical matter, however, title information may be made available to the farmee before the parties form the agreement so that the farmee can evaluate the feasibility of drilling within the time proposed.

71. In Oklahoma, for example, extensive title work prior to obtaining orders from the Corporation Commission spacing property for drilling is required. See *Harry R. Carlile Trust v. Cotton Petroleum Corp.*, 732 P.2d 438 (Okla. 1986), *cert. denied*, 55 U.S.L.W. 3871 (U.S. June 30, 1987). In *Carlile* the Oklahoma Supreme Court held that publication notice to those whose interests are affected by spacing is constitutionally insufficient if the applicant could ascertain their identity with due diligence, because establishment of spacing units is an adjudicative function of the Corporation Commission. *Id.* at 444. Locating those owners and giving them notice is time-consuming as well as expensive.

72. In Texas, for example, the Railroad Commission may require special proceedings if the farmout well is to be drilled on an exception tract under rule 37, or if sour gas may be anticipated under rule 36.

73. See generally Trower, *Enforceability of Letters of Intent and Other Preliminary Agreements*, 24 ROCKY MTN. MIN. L. INST. 347 (1978) (discusses whether parties have formed binding contract or have merely engaged in preliminary negotiations).

74. 556 S.W.2d 365 (Tex. Civ. App.—Amarillo 1977, no writ).

75. *Id.* at 367.

76. *Id.*

replying, Smith drilled on the premises and claimed the right to a farmout of Sabine's interest. A Texas court of civil appeals rejected the claim on the ground that the parties had never agreed to be bound.<sup>77</sup>

A more recent case on point is *Getty Oil Co. v. Blevco Energy, Inc.*<sup>78</sup> Blevco Energy requested a farmout of certain leases from Getty, and Getty replied that "Getty Oil will farmout to Blevco Energy, providing a mutually acceptable agreement can be resolved . . . ."<sup>79</sup> Subsequently, however, Getty drilled upon the property itself and completed an excellent well. Blevco sued Getty, and the trial court awarded Blevco Energy \$2 million in actual damages and \$4 million in punitive damages. The appellate court reversed on the grounds that no contract existed; the parties had merely an agreement to agree.<sup>80</sup>

These cases suggest that the best course is to state clearly in any letter exchange whether or not the parties intend to create a binding agreement.<sup>81</sup> In addition, an offer to farmout should be subject to a specific termination date.<sup>82</sup>

At least two writers have urged that farmout agreements ought not be entered into in the form of "letter agreements," an exchange of letters, or a letter signed by both of the parties.<sup>83</sup> Letter agreements may be a perfectly adequate vehicle for a contract, of course, and they are appealing because of their apparent simplicity. The problem is that "the nature of a letter agreement makes it improbable that the parties have included detailed provisions which will apply in the event the transaction does not progress as expected."<sup>84</sup> The better practice is to take the extra step of preparing a formal farmout agreement.<sup>85</sup>

77. *Id.* at 368-69.

78. 722 S.W.2d 51 (Tex. App.—Eastland 1986, no writ).

79. *Id.* at 53-54.

80. *Id.* at 54.

81. See Schaefer, *supra* note 3, at 18-1, -8; see also *infra* note 85 (illustrates language used in this type of farmout agreement).

82. The following clause limits the duration of the farmout offer: "9. EXECUTION. This Farmout Agreement shall be null and void at Farmor's option if the duplicate original hereof enclosed herewith is not executed by Farmee and returned to Farmor within — days after the date shown below Farmor's signature." T. FAY, *supra* note 3, at 48.

83. Cage, *supra* note 3, at 156; Scott, *supra* note 3, at 65.

84. E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 618. Petroleum Fin. Corp. v. Cockburn, 241 F.2d 312 (5th Cir. 1957), exemplifies the complications that may occur with letter agreements. In *Petroleum Fin. Corp.* the parties disagreed, and the court found that the letters and telegrams exchanged were ambiguous as to whether the farmor warranted a present title subject to defeasance or merely agreed to transfer merchantable title in the future. *Id.* at 317-18.

85. The parties might include the following language, modeled upon language suggested by Schaefer, *supra* note 3, at 18-9, in routine proposal letters:

[insert if the parties intend to be bound] We agree that the copy of this letter executed by both of us shall constitute a binding agreement between us to all of the terms and conditions set forth. We anticipate, however, that we will execute a formal farmout agreement at a later date, the provisions of which will replace and supersede this agreement in all respects.

[insert if the parties do not intend to be bound] We agree, however, that this is a preliminary letter of intent that shall not create any legally binding obligations between us until we have executed a formal farmout agreement.

#### 4. *Satisfying the Statute of Frauds*

Virtually all United States jurisdictions have adopted the statute of frauds to minimize disputes and fraud. The rationale for the statute is that certain kinds of agreements are so prone to dispute and outright fraud that they should be unenforceable unless they are evidenced by a writing.<sup>86</sup>

Farmout agreements fall within the scope of the statute of frauds if they are contracts for the transfer of an interest in land.<sup>87</sup> Most states probably will so classify farmout agreements, whether the interest created by an oil and gas lease is viewed as an estate in land or as a profit à prendre,<sup>88</sup> and whether the form of the contract is an agreement to convey or a conditional transfer. An oil and gas lease creates an interest in land whether it is classified as a fee simple determinable estate in the minerals or a profit à prendre. The lease's subject matter is an interest in land<sup>89</sup> whether the farmout agreement is in the form of a bilateral contract or a unilateral contract. Only in states that treat the oil and gas lease as a mere license can one argue that the farmout agreement need not comply with the statute of frauds. Courts will likely apply the statute even in those states, however.<sup>90</sup>

Compliance with the statute of frauds does not require a formal contract. Compliance occurs if there is "some memorandum or note thereof . . . in writing, and signed by the party to be charged therewith" or that party's agent.<sup>91</sup> On the other hand, it is not enough that there is a formal instrument. To comply with the statute of frauds, a contract must identify the parties and the subject matter, and a bilateral contract requires consideration.<sup>92</sup>

##### *a. Authority of an Agent*

A common statute of frauds issue that arises in a variety of oil and gas contract contexts is the authority of the agent who executes the contract.

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86. The recital to the Statute of Frauds, 29 Car. 2, ch. 3 (1677), stated that its object was the "prevention of many fraudulent Practices, which are commonly endeavored to be upheld by Perjury and Subornation of Perjury." See also Willis, *The Statute of Frauds—A Legal Anachronism*, 3 IND. L.J. 427 (1928) (discusses historical background of statute of frauds).

87. See, e.g., OKLA. STAT. ANN. tit. 16, § 4 (West 1986). Interestingly, TEX. BUS. & COM. CODE ANN. § 26.01(b)(4) (Vernon 1968 & Supp. 1987) applies only to contracts for the "sale of real estate." In any event, an oil and gas lease is "real estate" under Texas law, and a farmout agreement is subject to the statute of frauds. *White v. McNeil*, 294 S.W. 928, 930-31 (Tex. Civ. App.—Fort Worth 1927, no writ).

88. See E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 109.

89. J. LOWE, *supra* note 9, at 29.

90. Although Kansas, for example, has embraced the ownership-in-place theory of oil and gas rights, Kansas considers an oil and gas lease as personal property, a mere license. Nonetheless, Kansas courts have held oil and gas leases subject to the statute of frauds. For an excellent discussion, see D. PIERCE, *KANSAS OIL AND GAS HANDBOOK* § 4.11 (1986). See also *Lohse v. Atlantic Richfield Co.*, 389 N.W.2d 352 (N.D. 1986), holding that an oral agreement or bonus, royalty, and delay rentals did not create an enforceable contract even though the parties agreed to use a "standard form."

91. 8 Stat. 405, § 4, 24 Car. 2, ch. 3, § 4; *Lynch v. Davis*, 181 Conn. 434, 435 A.2d 977, 980 (1980).

92. RESTATEMENT OF CONTRACTS § 207 (1932); RESTATEMENT (SECOND) OF CONTRACTS § 131 (1979).

Most oil and gas contracts are between corporations, partnerships, limited partnerships or other forms of business entities, rather than individuals, because of the magnitude of the financial obligations involved. The question of whether or not the individual who purports to act for a corporation or a limited partnership actually has the authority to act is always a potential problem.

Representations in the agreement can minimize the problem. While representations of agency cannot create powers that do not exist, they may stimulate a disclosure of limited authority from the negotiator. Furthermore, if others in the negotiator's organization who have authority to bind it are aware of the negotiator's representations, a basis for a finding of apparent authority may be laid.<sup>93</sup> The only certain way to ensure that the agent signing the agreement has authority is to require a properly executed power of attorney or a certified copy of evidence of authority.

*b. Designation of the Parties*

The statute of frauds requires that the parties to the agreement be identifiable.<sup>94</sup> Failure to do so will cause the agreement to be unenforceable. *Cohen v. McCutchen*<sup>95</sup> provides a good example. In *Cohen* the contributing party made and signed a support agreement proposal in a form that failed either to state the name of the party to receive the contribution or to provide for his signature.<sup>96</sup> The Texas Supreme Court upheld summary judgment against the administrator of the estate of the party who was to receive the contribution on the ground that the statute of frauds requires that both parties be identifiable from the written agreement or supporting memoranda.<sup>97</sup>

The statute of frauds does not require that the parties to a contract for the transfer of an interest in land be named.<sup>98</sup> Compliance with the statute occurs if they are described sufficiently to permit their identity to be established by parol evidence. Thus, a reference in a farmout agreement to a "farmor" who is the "owner" of specifically described leases should satisfy the statute.<sup>99</sup>

There are important practical reasons, however, for specifically naming the parties to the farmout agreement and indicating addresses and telephone numbers of each in the agreement. Under the terms of the agreement or in the event of emergencies, notices may need to be given or communication established. Having the vital information ready at hand in the body of the agreement will save time and minimize confusion. A well-drafted farmout

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93. Apparent authority is "[S]uch authority as a principal intentionally or by want of ordinary care causes or allows third person to believe that agent possesses." BLACK'S LAW DICTIONARY 88 (5th ed. 1979); see also W. SEAVEY, HANDBOOK OF THE LAW OF AGENCY § 8(D) (1964) (similar definition of apparent authority).

94. TEX. BUS. & COM. CODE ANN. § 26.01 (Vernon 1987).

95. 565 S.W.2d 230 (Tex. 1978).

96. *Id.* at 232.

97. *F. & W. Grand Co. v. Eiseman*, 160 Ga. 321, 127 S.E. 872, 876 (1925).

98. See *id.*, 127 S.E. at 875 (reference to "lessor" as "owner" held sufficient).

99. See *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 908-11 (Tex. 1982).

agreement will have no difficulty meeting the statute of frauds requirement that the parties be identifiable.

*c. Identification of the Land Covered*

The agreement must sufficiently describe the land subject to a farmout agreement to permit it to be located to meet the standard of the statute of frauds.<sup>100</sup> This requirement can pose a problem, particularly in those farmout agreements that are in letter form and refer only generally to the leases and areas covered. *Westland Oil Development Corp. v. Gulf Oil*<sup>101</sup> illustrates the principles applicable. In *Westland* an area of mutual interest clause in an assignment of the farmee's rights under a farmout agreement provided as follows:

5. If any of the parties hereto, their representatives or assigns, acquire any additional leasehold interests affecting any of the lands covered by said farmout agreement, or any additional interest from Mobil Oil Corporation under lands in the area of the farmout acreage, such shall be subject to the terms and provisions of this agreement.<sup>102</sup>

The Texas Supreme Court held that the reference to "lands covered by said farmout agreement" satisfied the statute of frauds because the letter agreement specifically identified "said farmout," and the farmout agreement identified contained a specific description of the land subject to the leases.<sup>103</sup> The court deemed the reference to "lands in the area of the farmout acreage" insufficient to permit introduction of parol evidence to determine the intent, however.<sup>104</sup> The court said that parol evidence "should be used only for the purpose of identifying the land with reasonable certainty from the data in the memorandum, and not for the purpose of supplying its location or description."<sup>105</sup>

A similar issue with a similar result arose in *Stekoll Petroleum Co. v. Hamilton*.<sup>106</sup> In *Hamilton* the farmout arrangement extended to the farmee the right to choose 4000 acres from a 5000-acre block of land, leaving the farmers with 1000 acres "equitably checkerboarded in a fashion similar to the checkerboarding in" another block.<sup>107</sup> The Texas Supreme Court held that the agreement failed to describe adequately the property in question because the agreement did not clearly define the checkerboard pattern and because the contract did "not contain the statement of data or means or a method by which . . . the land will be certainly and clearly identified."<sup>108</sup>

These two cases illustrate that the description of leases subject to the

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100. *Id.* at 908.

101. 637 S.W.2d 903 (Tex. 1982).

102. *Id.* at 905.

103. *Id.* at 909.

104. *Id.*

105. *Id.* at 910; see also *Getty Oil Co. v. Blevco Energy, Inc.*, 722 S.W.2d 51, 53 (Tex. App.—Eastland 1986, no writ) (failure of any writing to identify property allegedly subject to farmout agreement provided court alternative ground for reversing trial court).

106. 152 Tex. 182, 255 S.W.2d 187 (1953).

107. *Id.* at 188-90, 255 S.W.2d at 191.

108. *Id.* at 190-92, 255 S.W.2d at 192.

farmout agreement must be as detailed and explicit as possible. The parties should use a proper legal description, rather than a plat map.<sup>109</sup> The description should include the legal description of the property, the source of the legal description, the names of the lessor and lessee, and the recording information for the leases farmed out. The description may also refer to depth limitations or lease burdens. The information frequently will be so lengthy that it will be included in an exhibit attached to the farmout agreement.<sup>110</sup>

#### d. Consideration

The statute of frauds requires that consideration, expressly or impliedly stated in the agreement, must support a bilateral contract.<sup>111</sup> Farmout agreements occasionally specifically recite that monetary consideration has been given,<sup>112</sup> though whether it is actually paid is often doubtful. When the farmout agreement makes drilling an obligation of the farmee, however, one can find consideration in the promises that the parties make to one another. Consideration in the form of a promise for a promise is the essence of a farmout agreement in which drilling is mandatory. The more typical option-to-drill farmout agreement may be classified as a unilateral contract, which needs no consideration.<sup>113</sup>

### 5. Coordination with Farmed-Out Leases

It is axiomatic that the farmee can get no better rights under a farmout agreement than the farmor owns under the leases subject to the agreement. Often, however, the parties to a farmout agreement fail to examine the terms and the validity of the leases farmed out. Rarely are proposed farmout agreements presented with copies of the subject leases attached. The parties will likely execute the farmout agreement without a close examination of the

109. In *Heirs & Unknown Heirs of Barrow v. Champion Paper & Fibre Co.*, 327 S.W.2d 338 (Tex. Civ. App.—Beaumont 1959, writ ref'd n.r.e.), the court of appeals held that a map of a subdivision drawn on a scale of one inch to 800 feet was too uncertain to fix the location because "even the width of a line drawn upon the map must represent several feet." *Id.* at 347.

110. For example:

#### EXHIBIT "A"

Attached to and made a part of that certain Farmout Agreement dated (date), from (Name of Farmor) to (Name of Farmee)  
Oil, Gas and Mineral Lease dated \_\_\_\_\_, between \_\_\_\_\_, as Lessor, and \_\_\_\_\_, as Lessee, recorded in Volume \_\_\_\_\_, Page \_\_\_\_\_ of the Oil and Gas Records of \_\_\_\_\_ County, Texas, covering the following described lands situated in said county and State:  
\_\_\_\_\_ acres, more or less, being the \_\_\_\_\_ Survey, \_\_\_\_\_ of \_\_\_\_\_ County, Texas, and described in a Deed from \_\_\_\_\_ to \_\_\_\_\_ dated \_\_\_\_\_, and recorded in Volume \_\_\_\_\_, Page \_\_\_\_\_ of the Deed Records of \_\_\_\_\_ County, Texas.

111. RESTATEMENT (SECOND) OF CONTRACTS § 131 comment h (1979); see also *Lynch v. Davis*, 181 Conn. 434, 435 A.2d 977, 979 (1980); *Briand v. Wild*, 110 N.H. 373, 268 A.2d 896, 897-98 (1970).

112. For example, one major oil company uses forms that begin, "For sufficient consideration, receipt of which is hereby acknowledged . . . ."

113. See RESTATEMENT (SECOND) OF CONTRACTS § 131 comment h (1979). Performance supplies consideration for a unilateral contract. *Id.*

leases being farmed out since most farmout transactions make drilling an option rather than a firm obligation.

The farmor and the farmee both take risks if they fail to examine the leases subject to the farmout. *Isler v. Texas Oil & Gas Corp.*<sup>114</sup> illustrates a risk to the farmee. In *Isler* TXO farmed out an oil and gas lease on federal lands in New Mexico to Isler. TXO made the farmout without warranty of title. The agreement provided that TXO would make delay rental payments or give Isler notice before ceasing to make them, but it specifically stated that TXO would have no responsibility to Isler for a failure to make the payments.<sup>115</sup> TXO, through oversight, failed to make rental payments, and the lease expired. Isler completed two wells on the premises before learning that the lease had expired. Isler sued TXO, claiming damages both on a theory of breach of contract and on a theory of tort. A federal court jury awarded damages against TXO for negligence.<sup>116</sup> The Tenth Circuit reversed, applying New Mexico law, on the ground that the farmout agreement meant what it said:

The effect of confusing the concept of contractual duties, which are voluntarily bargained for, with the concept of tort duties, which are largely imposed by law, would be to nullify a substantial part of what the parties expressly bargained for—limited liability. Unless such bargains are against public policy (covered either by prohibitory statutes or well-defined, judge-made rules such as unconscionability), there is no reason in fact or in law to undermine them. Indeed, it would be an unwarranted judicial intrusion into the marketplace.<sup>117</sup>

The farmor may also hurt itself by failing to coordinate the terms of the farmout with the underlying leases. In *Davis v. Zapata Petroleum Corp.*<sup>118</sup> Davis farmed out to Zapata under a farmout agreement that required Zapata to commence drilling and continue either until Zapata achieved production or until thirty days after Zapata provided Davis notice of its intent to cease operations. Zapata commenced drilling three days before the end of the primary term, but then gave Davis notice of its intent to cease. Davis accepted the notice, took over the well, and found another farmee. The lessor subsequently evicted the new farmee from the land on the grounds that the lease had terminated because operations had ceased for longer than the period permitted by the lease operations clause.<sup>119</sup> Davis sued Zapata for damages it had incurred, but lost in a jury trial. A Texas court of civil appeals upheld the judgment on the basis that the farmout agreement set Zapata's obliga-

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114. 749 F.2d 22 (10th Cir. 1984).

115. This provision is typical in farmout agreements. The *Isler* case does not quote the applicable provisions, but many of the farmout agreements collected included formulations of similar effect. See *infra* text accompanying notes 352-53.

116. 749 F.2d at 22.

117. *Id.* at 23.

118. 351 S.W.2d 916 (Tex. Civ. App.—El Paso 1961, writ ref'd n.r.e.).

119. A lease operations clause addresses the problem of drilling operations that are begun, but not completed by the end of the primary term. The clause defines drilling operations, generally deemed to be in progress when continuing for more than a 30-, 60-, or 90-day period, as constructive production for purposes of the lease habendum clause. See E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 188-98.

tions rather than the lease.<sup>120</sup> The court noted that "such requirements might well have been greater, or less, than those required to maintain the oil and gas lease in effect."<sup>121</sup>

These cases clearly and consistently apply the principle that a farmout agreement means what it says. The courts will not include by implication in the farmout agreement requirements of the leases that are farmed out or motivation of the parties. Thus, it is crucial that the parties to a farmout identify the important components of the leases being farmed out and incorporate them specifically in their agreement.

## 6. *Drafting Techniques*

Drafting is an art rather than a science. Every drafter has favorite techniques, and few agree as to what works best. Experts in the area do agree, however, that "if it may be ambiguous, it *is* ambiguous."<sup>122</sup> Clarity of meaning is the goal, and the following techniques may be helpful.

### a. *Use of Prefatory Statements of Purpose*

When the primary purpose of the farmout can be identified—for example, to preserve a lease about to expire or to test a particular formation—one should include a prefatory statement of that purpose. The courts struggle to make sense of the instruments before them, as do managers in oil companies and their counsel. A clear statement of the purpose of an agreement may avoid disputes or lend support to the interpretation urged.

*Pasotex Petroleum Co. v. British American Oil Producing Co.*<sup>123</sup> illustrates the usefulness of prefatory statements. In *Pasotex Petroleum Co.* the Oklahoma Supreme Court held that a farmee abandoned performance of a farmout agreement when it failed to drill a well to test a deep formation, but completed a well in a shallower formation. The court reasoned that:

Our examination of the record convinces us that the paramount idea and purpose on the part of defendant in negotiating and making the agreements with plaintiff was to secure a deep test well that would test the productivity of the Basal Oil Creek Sand. In addition to the value of a producing well from this sand there was also the important feature of the geological knowledge that defendant would acquire and the influence this would have on defendant in determining whether it would expend the large sums . . . necessary in securing renewals of a large number of leases that would soon expire. Such a test well was not drilled.<sup>124</sup>

The result turned on the finding of the purpose of the agreement. Extrinsic evidence had to be introduced to prove the point, however. A prefatory statement might have avoided litigation, and made the result more certain.

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120. 351 S.W.2d at 925.

121. *Id.*

122. *See supra* note 4.

123. 431 P.2d 373 (Okla. 1966).

124. *Id.* at 381.

b. *Use Appendices for Standard or Complex Provisions*

Many of the farmout agreements collected did not attempt to deal with standard or detailed provisions in the body of the agreement, but instead attached appendices containing these terms.<sup>125</sup> This drafting technique offers a number of advantages. First, it makes possible an apparently simple, purpose-oriented farmout agreement. Second, it discourages those who negotiate the agreement from making changes in provisions that the lawyers may view as important boilerplate. Third, the technique minimizes the opportunities for ambiguity or conflict between the terms of the farmout agreement and related instruments, such as the assignment.<sup>126</sup>

Use of appendices has a single, but substantial, disadvantage. That disadvantage is the risk that those negotiating the agreement will regard the appendices as incidental to the transaction and thus not give them the attention that they deserve.<sup>127</sup> Negotiators can easily fall into the trap of regarding appendices as unimportant.

c. *Define the Terms Used*

Persons active in the oil business often think of the industry as a monolithic whole, although the better view probably is as a group of regional industries. Both practices and terminology differ from place to place. Parties therefore must define carefully the terms used in a farmout agreement, either in the text of the contract as they are used or in a separate definitions section.<sup>128</sup>

Even commonplace terms may be considered ambiguous. In *Holly Energy, Inc. v. Patrick*<sup>129</sup> the farmout agreement provided that a well capable of producing in paying quantities would earn "that portion of the captioned quarter section situated within the production unit established for that well."<sup>130</sup> The farmor assigned its interest in two full quarter sections,

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125. See, e.g., Exhibit A to the agreements of Sun Exploration and Production Company discussed in T. FAY, *supra* note 3, at 55-58, which includes many of the substantive provisions addressed in this paper in four pages of fine print.

126. A nightmare for the lawyer or administrator working with farmouts is that the terms of an assignment made pursuant to a farmout agreement will be inconsistent with the terms of the farmout. Whether the terms of the assignment comport with the farmout is often a point of dispute between farmor and farmites. See, e.g., *Holly Energy, Inc. v. Patrick*, 239 Kan. 528, 722 P.2d 1073, 1074-75 (1986). For a discussion of *Holly Energy*, see *infra* notes 129-32 and accompanying text. An obvious problem of merger will arise if that occurs. One correspondent who responded to my request for comments, Dean Eugene Kuntz, suggested that the parties might draft the farmout to refer to an assignment to be made "on the attached form of assignment covering the lands, leases and interests, and subject to the limitations set forth, in such form of assignment." This suggestion would minimize the possibilities for conflict between the terms of the assignment and the terms of the farmout relating to the assignment.

127. See Lamb, *supra* note 3, at 141 (criticizing the "conglomerate mess" that may result).

128. One of the agreements collected devoted nearly two full pages to definition of terms, including contract lands, leases, earning well, subsequent well, drilling unit, contract depth, well costs, operating costs, leasehold costs, lease maintenance costs, casing point, working interest, working interest percentage, and operator. See also art. II of the short form farmout agreement attached to Bledsoe, *supra* note 3, ex. 1.

129. 239 Kan. 528, 722 P.2d 1073 (1986).

130. 722 P.2d at 1075 (emphasis in original).

though the spacing pattern for the two wells was only forty acres. The farmor later asserted that the farmee should have received only assignments of the forty-acre well sites. The Supreme Court of Kansas affirmed a trial court's refusal to grant the farmor relief on a variety of claims, upholding the trial court's finding that the term "production unit" was ambiguous.<sup>131</sup> The court pointedly noted that "it would have been a simple matter for Holly to clearly state in the farmout agreement that only one well was contemplated and that if successful Patrick would receive an assignment as to forty acres only."<sup>132</sup> A complete definitions section, though rarely seen, is advisable.

### B. Key Characteristics of a Farmout

When one shifts from preliminary matters to substantive analysis, it is important to determine the key characteristics of any farmout proposal or agreement. On these provisions may turn the likelihood of the transaction's business success or failure. The key characteristics of a farmout agreement generally include the provisions relating to (1) the duty imposed, (2) the earning factor, (3) the interest earned, (4) the number of wells to be drilled, and (5) the form of the agreement.

#### 1. *The Duty Imposed: Option or Obligation*

People in the industry frequently classify farmout agreements as "option farmouts" or "obligation farmouts." An option farmout agreement provides that drilling is a condition of the farmee's earning the agreed interest. An obligation farmout agreement is one in which drilling is a promise by the farmee.<sup>133</sup> If drilling is an option, it is a condition of earning. If drilling is an obligation, it is a covenant—a legally binding promise.

All things being equal, the farmor would probably always prefer to structure the farmout agreement so that the farmee covenants to drill. All things are rarely equal in negotiations, however, and the vast majority of farmout agreements make drilling an option rather than an obligation. This situation may indicate that lease salvage is a common motivation.<sup>134</sup> It may also reflect the attitude of the farmors' managements as to what is fair.<sup>135</sup> Perhaps most likely, drilling as an option results from simple economics. In the usual farmout situation, the farmee holds the bargaining leverage. The farmor

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131. *Id.* at 1079.

132. *Id.*

133. An obligation farmout should not be confused with a farmout in which the farmor's purpose is to have drilled an obligation well. *See supra* text accompanying notes 67-69. The former refers to the structure of the agreement. The latter refers to the motivation of the farmor in entering the agreement. In fact, however, a farmout given because the farmor needs to have an "obligation well" drilled will almost certainly be structured as an "obligation farmout." On the other hand, farmouts motivated by other purposes may also be so structured.

134. *See supra* text accompanying note 62.

135. The vice president for land of a large independent oil company once told the author that his company, as a farmor, would never insist that a farmee covenant to drill because it was as often a farmee as a farmor. While that statement may have been an exaggeration, what the deal-makers regard as ethical or good business practice certainly may affect the structure of agreements.

wants to "move" the leases being farmed out and so the farmee, which is understandably reluctant to make a firm commitment to drill, can negotiate an option to drill.

The primary significance of classifying a farmout agreement as an option farmout or an obligation farmout is the effect of failure to perform under the agreement. When the farmout is structured as an option to drill, failure to drill will cost the farmee the benefits it might have earned. When the farmee is obligated to drill, however, failure to drill may expose the farmee to very substantial liabilities.<sup>136</sup> The classification of the agreement as an option farmout or obligation farmout may also affect the rights of the parties in the event of bankruptcy.<sup>137</sup>

## 2. *The Earning Factor: Produce to Earn or Drill to Earn*

A second way to categorize farmout agreements for analytical purposes is by reference to what will earn an interest for the farmee. A produce-to-earn farmout agreement is drafted so that the farmee earns an interest in the property being farmed out by drilling and completing a well capable of producing in paying quantities. A drill-to-earn farmout agreement requires less. The farmee can earn its interest merely by drilling to a specified formation or formations and conducting agreed testing.

*Lansinger v. United Petroleum Corp.*<sup>138</sup> illustrates the importance of the distinction between produce-to-earn and drill-to-earn farmouts. In *Lansinger* the farmee drilled a well under a farmout requiring completion of a well capable of producing in paying quantities, but the farmee neither hydraulically fractured it nor equipped it to produce. The court quieted title in favor of the farmor, noting that it was not sufficient "to complete a well having some indications of oil, or a well which might be developed into a well producing oil in paying quantities,"<sup>139</sup> and denied the farmee additional time to complete the well.<sup>140</sup>

The produce-to-earn farmout, which was the subject in *Lansinger*, is the more usual because the most common motivation for a farmor to farm out is to preserve a lease, and a party cannot maintain a lease without a well capable of producing in paying quantities. A drill-to-earn farmout structure is usually found in agreements where the farmor is motivated by a desire to explore. Conceptually, this structure is closely related to an acreage contribution agreement.<sup>141</sup> Parties will likely use both as part of a coordinated

136. Thus, when drilling is an obligation rather than an option, the farmee must determine its ability to perform before entering into the agreement. In addition, the farmee must also have examined the title of the farmed-out properties before committing itself to an obligation to drill. In the alternative, the agreement may provide that the farmee has a specified period of time to review title and to reject it without liability. Lamb, *supra* note 3, at 160; see *infra* note 162 and accompanying text.

137. See *infra* text accompanying notes 859-72.

138. 14 Ohio App. 3d 398, 471 N.E.2d 869 (1984).

139. 471 N.E.2d at 871 (quoting *Murdock-West Co. v. Logan*, 69 Ohio St. 514, 69 N.E. 984, 985 (1904)).

140. *Id.* at 872.

141. See *supra* text accompanying note 14.

exploratory program to evaluate an area. Drill-to-earn farmout agreements may also be used when the well to be drilled is an obligation well. A dry hole will satisfy the legal obligation as effectively as a producing well when the farmor farms out to satisfy an implied covenant to its lessor.

### 3. *The Interest Earned: Divided Interest, Undivided Interest, or Combination*

A divided interest farmout provides that the farmee and the farmor end up owning interests in separate tracts. A simple example is an agreement by which a farmee earns all of the farmor's interest in a specified lease for drilling. Another example is a farmout, perhaps entered into to preserve a lease, that allows the farmee to earn the farmor's interest in a drillsite tract for drilling and completing a well capable of producing in paying quantities, yet leaves the farmor with the full leasehold interest in the acreage outside the drillsite tract.<sup>142</sup> A variation, called a "checkerboard" scheme, provides that the farmee earns the farmor's interest in drillsite acreage plus the farmor's interest in every other drillsite unit around the drillsite tract, leaving the farmor the interest in the remaining tracts.<sup>143</sup>

An undivided interest farmout provides that the farmee earns an undivided portion of the farmor's interest in a tract. For example, a farmee may earn 75% of the farmor's interest in only the drillsite in return for paying 75% of drilling costs, so that the farmor and the farmee become tenants in common. Such arrangements frequently arise when a farmor's primary reason for farming out is lack of cash. By assigning a part of its interest, the farmor gets a lease developed that it would not otherwise be able to drill, while maintaining a percentage interest.<sup>144</sup>

Many farmouts are structured so that the farmee earns a combination of divided and undivided interests. The classic farmout structure gives the farmee a divided 100% interest in the drillsite acreage until payout and an undivided interest in acreage outside the drillsite.<sup>145</sup> Parties frequently use combination farmouts when the object of the farmout agreement is to test large undeveloped tracts.

Classification of a farmout as a divided interest farmout or an undivided interest farmout is of primary significance in determining how much emphasis analysis should place upon the ongoing relationship of the farmor and the farmee. If the farmout is of a divided interest, then once the farmee has earned its divided interest in a given tract, the relationship of the parties is no more complicated than that of any other two owners of adjacent properties. Analysis of a divided interest farmout thus should focus on what the farmee has to do to earn its interest. When the parties are to end up owning

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142. For examples of well site only assignments, see *infra* notes 275-76.

143. For an example of a checkerboard assignment, see *Stekol v. Hamilton*, 152 Tex. 182, 255 S.W.2d 187, 190-91 (1953). See also 8 H. WILLIAMS & C. MEYER, *supra* note 12, at 119.

144. See *supra* text accompanying notes 22-25 for a discussion of the complete payout tax concept, which is apparently satisfied so long as the farmee maintains an interest in the well for the payout period equal to the percentage of the IDCs it pays.

145. See *supra* text following note 32; *infra* note 277.

undivided interests, however, the ongoing relationship of cotenants will require that close attention be given to those provisions of the farmout and operating agreements that relate to the ongoing duty of the parties to one another and to their lessors, as well as to what has to be done to earn.

#### 4. *The Number of Wells: Single or Multiple Well Farmouts*

In the classic farmout arrangement, the farmee earns an interest in the farmor's acreage by drilling a single well. When large tracts of land are involved, however, farmout agreements frequently require that several wells be drilled.

A multiple well farmout agreement is substantially more complicated than a single well agreement. The parties must carefully define the timing of drilling operations for wells after the first well to be certain that the farmee has adequate time to complete one operation before beginning another. The farmout's testing provisions must be considered to determine whether the tests required in the drilling of the initial well must also be required in subsequent wells. The parties must include provisions to address what happens if the farmee completes some, but not all, of the multiple wells contemplated. Typically, multiple well farmout agreements will provide that the farmee will keep producing wells that it has completed.<sup>146</sup> Such is not always the case, however; some multiple well farmouts punish the farmee for failure to perform fully.<sup>147</sup>

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146. For example:

In addition to any other remedies which may be available to Farmor, its successors and assigns hereunder, this Agreement shall terminate and be of no further force and effect should Farmee fail to drill any of the Test Wells required by, and in the manner specified by, the terms and provisions of this Agreement. *However, this provision shall not cover acreage which has been previously drilled and subleased in accordance with the terms and provisions of this Agreement.*

(Emphasis added.)

147. The following provision, for example, would give the farmee only half of the acreage it is to earn if it fails to drill all the wells promised:

If Farmee, as Farmee may so do without breaching its obligations under this Agreement, shall fail to complete the drilling, testing and equipping of all of said six (6) net wells in the manner and within the time provided in this Agreement then Farmee shall have earned, and shall be entitled to receive an assignment from Farmor covering, the following leasehold interests, to-wit:

- (i) As to each of said test wells completed by Farmee for production, an undivided one-half of Farmor's right, title and interest (subject to the proportionate share of presently-existing burdens and obligations) in the leases set forth in Exhibit "A" insofar as said leases cover the government-surveyed section of land on which each of such wells is located, but only insofar as said leases cover the interval from the surface to the base of the \_\_\_\_\_ Formation; such well, the equipment and material therein and thereon and the production therefrom shall be owned equally by the parties hereto and shall be operated in accordance with the Operating Agreement attached hereto;
- (ii) as to each of said test wells completed as a dry hole by either Farmee or Farmor, Farmee shall be entitled to assignments covering an undivided one-half of Farmor's right, title and interest (subject to a proportionate share of presently existing burdens and obligations) in the leases set forth in Exhibit "A" insofar as said leases cover the government-surveyed sec-

### 5. *The Form of the Agreement: Agreement to Transfer or Conditional Assignment*

Farmout agreements traditionally have taken the form either of an agreement to convey or a conditional assignment. The essential difference in the two is the point in time when the farmee acquires an interest in the farmed-out property. When the farmout is in the form of an agreement to convey, the farmee obtains its rights only if it performs the conditions made prerequisite by the contract.<sup>148</sup> When the farmout is in the form of a conditional assignment, the farmee obtains an interest in the farmed-out property when the agreement is made, subject to an obligation to reconvey or to automatic termination if the conditions subsequent are not performed.<sup>149</sup>

The farmout's form may have enormous practical significance to the parties' rights and liabilities. The farmor's primary advantage in structuring a farmout as a contract to convey rather than a conditional assignment is that the farmor retains title to the property farmed out until after the farmee has performed. Administratively, this is simple for the farmor, and it saves the time and effort required to clear title in the event that the farmee does not perform. In addition, structuring a farmout as a contract to convey may mitigate the problems of liens being attached due to the farmee's default or of claims as a result of the farmee's bankruptcy.<sup>150</sup>

The farmee's interests virtually mirror the farmor's. The farmee, under a conventional agreement to transfer farmout, may find the farmor slow to provide the earned assignment or inclined to quibble over whether it is really due. Further, the assignment when finally made may come burdened with liens attached while the farmee was drilling the earning well. If the farmor should go bankrupt before the assignment is made, the farmee may never get the assignment.

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tion of land on which such well is located, and insofar as such leases cover the interval from the surface to the base of the \_\_\_\_ Formation.

As to each such producing well, Farmee shall retain ownership of the material, equipment and supplies located therein and thereon; providing, however, Farmor shall have free use of each such property and the production from each such well shall be owned equally by Farmor and Farmee; it being understood that maintenance and operating costs shall be shared by Farmor and Farmee in accordance with the terms of the Operating Agreement, Exhibit "D" attached hereto. Should such property be transferred, sold, salvaged or otherwise disposed of, Farmor shall receive 50% of the proceeds or credits received therefrom.

This provision would subject the farmee to the ravages of the complete payout limitation as well, because the farmee would not earn the full interest in the well site acreage and would lose a part of the IDC deduction.

148. See, e.g., *Lansinger v. United Petroleum Corp.*, 14 Ohio App. 3d 398, 471 N.E.2d 869, 871-72 (1984); *Energy Reserves Group v. Tarina Oil Co.*, 664 S.W.2d 169, 172-73 (Tex. App.—San Antonio 1983, no writ).

149. See, e.g., *Vickers v. Peaker*, 227 Ark. 587, 300 S.W.2d 29, 31-34 (1957) (automatic termination); *Mengden v. Peninsula Prod. Co.*, 544 S.W.2d 643, 647-49 (Tex. 1976) (obligation to reassign).

150. For a discussion of bankruptcy and its effects on farmout agreements, see *infra* text accompanying notes 459-72.

## IV. ESSENTIAL ISSUES OF FARMOUT AGREEMENTS

Having considered preliminary matters and having noted the key characteristics of the agreement, the reviewer or draftsman is ready to analyze the essential issues that any farmout agreement must address. This section of the Article discusses the following issues: drilling the earning well, well information, what is earned, and administrative provisions.

A. *Drilling the Earning Well*1. *What Is Farmed Out*

Generally a farmout agreement covers leases owned by the farmor, but on occasion mineral rights may be farmed out as well. The leases and lands covered by the farmout may be described in the body of the farmout agreement. More often an appendix incorporated by reference contains this information. When the parties list leases subject to the farmout in an appendix, they may also include other information, such as existing burdens and lease terms. The obvious and easily avoidable problem is inaccuracies or discrepancies in description of the properties.<sup>151</sup>

The agreement may also provide that the farmee's rights will extend to extensions and renewals of the leases covered.<sup>152</sup> Extension and renewal provisions are unnecessary in the farmout if the operating agreement becomes effective when the farmout is executed, in which case the provisions in the operating agreement probably supersede those of the farmout agreement. In any event, extension and renewal provisions of farmout agreements often parallel operating agreement provisions.<sup>153</sup>

2. *Costs and Expenses*

Almost by definition, a farmout is an agreement by which the farmee agrees to pay the costs of the operations contemplated. Generally that undertaking is explicitly stated in the farmout.<sup>154</sup> As is discussed below, however, a provision that the farmee will be responsible for all costs and expenses is not a perfect shield against liability for the farmor.<sup>155</sup>

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151. See *supra* text accompanying notes 100-10.

152. The following example is a concise renewal and extension provision: "The interests reserved herein, or in any assignment hereunder, to Farmor shall apply to any renewal, extension, or new lease covering any part or all of the Contract Acreage that \_\_\_\_ may acquire, directly or indirectly, within two years after expiration of the Lease."

153. Compare Art. VIII.B. of the 1982 AAPL Model Form Operating Agreement with the provisions of the clause quoted *supra* note 152. Application of extension and renewal provisions frequently provide a source of dispute between farmors and farmees. See *Cage, supra* note 3, at 169-73.

154. For example: "The entire cost, risk and expense of drilling, testing, completing, equipping and operating the well(s) or of plugging and abandoning the well(s) and restoring the surface if a dry hole shall be borne by farmee." Of course, the parties must appropriately modify this language if the farmee will earn less than 100% of the working interest in well-site acreage and pay only the proportion of costs equal to the interest earned.

155. See *infra* notes 406-38 and accompanying text.

### 3. Failure of Title

Failure of title is a risk that is customarily imposed upon the farmee in farmout agreements. While in principle the farmor and the farmee should negotiate covenants of title from the farmor, farmout agreements rarely contain a general warranty of title by the farmor. None of the farmout agreement examples collected included a general warranty, and only a few contained a special warranty<sup>156</sup> or a specific representation.<sup>157</sup> Indeed, most of the contract examples included a disclaimer of any warranty,<sup>158</sup> and a few specifically placed the farmee on notice of possible title defects.<sup>159</sup> Some

156. A farmout special warranty follows:

Any assignment from farmor to farmee shall be without warranty except for a limited warranty as to the farmor's own acts in favor of farmee, including an express representation and warranty by farmor that the interest assigned is not subject to any obligation or burdens by or through farmor, other than the lessor's royalty. Also, farmor warrants that the interest to be assigned to farmee is free of any mortgage or any other encumbrance by or through farmor including indemnification of farmee from any loss or deficiency under such warranty or representation.

157. The following represents that the farmor holds title, but stops short of warranting it:

Farmors represent to the Farmee that to their best knowledge after reasonable investigation they own the working interests and the net revenue interests in the land and depths covered by said leases described in Exhibit "B"; that the only Agreements to which Farmors' interests in said leases are subject are the Agreements described in Exhibit "B"; that said leases are in full force and effect except for the following: \_\_\_\_\_; and that Farmors are free to assign their interests in said leases to Farmee on the terms of this Agreement without the consent of any third party. Farmors agree to use their best efforts to maintain said leases in full force and effect during the term of this Agreement prior to the commencement of the Initial Earning Well (as defined below) so that such leases remain in full force and effect during the term of this Agreement.

The following representations focus on the burdens of the leases farmed out, as well as title:

Farmor represents, but does not warrant that as of the date hereof, it owns an interest in the leasehold interest created by the lease at least equal to an undivided \_\_ interest therein, and that other than the landowner's royalties and one or more overriding royalty interests aggregating \_\_ percent of 8/8ths there are no other overriding royalty interests, production payments, net profits obligations, carried working interests and payments out of or with respect to production which are of record in the county and state identified on page 1 hereof and with which the lease is burdened as of the date hereof (the "existing burdens") so that the existing burdens aggregate a total of \_\_ percent of 8/8ths of production, and without regard to any non-consent provisions in the operating agreement and without making any provisions for operating costs, farmee will be entitled to receive \_\_ percent of \_\_ percent of the production attributable to its interests in the lease.

158. A specific disclaimer of warranty, for example, may state, "Farmor makes no representation with the respect to the status of their title to the leasehold interests covered hereby, and it is understood that this farmout is being given without warranty of title, either expressed or implied."

159. For example:

Farmor hereby expressly advises farmee that there is currently litigation pending which may directly or indirectly raise certain questions concerning title to the farmed out lands, and hereby specifically refers farmee to the following cases: \_\_\_\_\_. It is understood and agreed that any operations undertaken by farmee pursuant to this agreement are done so at its sole risk and expense without any representations of any kind or character made by farmor as to title to the farmed out lands.

states may imply title warranties from the use of words of grant,<sup>160</sup> so the parties should be specific as to their agreement.

#### 4. Title Information

Because the typical farmout agreement does not include a warranty of title, the farmee should satisfy itself that the farmor has title before conducting drilling operations. That task is made easier if the farmor will agree to share with the farmee title information that it may have, as is commonly done.<sup>161</sup> One reviewing a farmout agreement for a farmee should alert the farmee to the importance of actually obtaining and reviewing title documents relating to the leases farmed out. Particularly when the farmout agreement obligates the farmee to drill, rather than merely giving it an option, the agreement should provide that the farmee can withdraw from the agreement if it is not satisfied with title.<sup>162</sup>

#### 5. Geologic Information

The farmor will frequently agree to provide the farmee with whatever geologic and geophysical information and interpretations it has developed. The farmout agreement should specifically provide for the sharing of such information,<sup>163</sup> subject to disclaimers of accuracy and requirements of confidenti-

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160. See, e.g., TEX. PROP. CODE ANN. § 5.023 (Vernon 1984).

161. Bledsoe, *supra* note 3, at N-5. For example:

Upon request by Farmee following execution of this Agreement, Farmors shall provide the Farmee copies of said leases and copies of all title documentation material to the acreage subject to this Agreement in Farmor's files relating thereto, including without limitation copies of all title opinions and reports, rental receipts, and title curative documents. Such title documentation shall be provided without warranty by Farmors as to accuracy. Any title examination performed by Farmee with respect to the Initial Earning Well referred to below to be drilled on said leases shall be performed at the sole cost of Farmee and the Farmee shall deliver copies to Farmors of any title opinions or reports acquired by Farmee with respect to such well.

*Id.* For a discussion of *Isler v. Texas Oil & Gas Corp.*, 749 F.2d 22 (10th Cir. 1984), which illustrates the risk to the farmee of an inadequate title examination, see *supra* text accompanying notes 114-17.

162. An example of a clause giving the farmee a right to avoid the agreement in the event of defects is:

Farmor has furnished to farmee all material in farmor's possession relevant to the determination of farmor's title to the leases subject to this agreement. If farmee does not object to farmor's title of the leases in the manner described below by \_\_\_\_\_ farmee will be deemed to have accepted farmor's title to the leases. If farmee raises reasonable objections to farmor's title to the leases by a writing delivered to farmor by \_\_\_\_\_, farmor will have until \_\_\_\_\_ to cure any title objections to the reasonable satisfaction of farmee. Should farmor fail in this respect, this agreement shall become null and void.

163. For example:

Upon request of Farmee, Farmors shall provide Farmee with reproducible copies of any geological, geophysical or other information which Farmors have acquired with respect to said leases and which Farmors have the right to provide. Such information will include, but will not be limited to, maps, cross sections, and geological interpretations; field tapes and associated support data, final record sections (processed using standard processing techniques), shot point location maps and other materials related to any seismic operations conducted by

ality. In the alternative, the agreement should specifically indicate that the farmor will not share geologic and geophysical information.<sup>164</sup>

### 6. Location of the Well

If a farmor's purpose in entering into the farmout agreement is to save its lease, it may be willing to let the farmee drill at a location of its choice.<sup>165</sup> If, however, the farmor's purpose is to obtain geologic information or to satisfy an express or implied covenant of a lease, the farmor may designate the location precisely. *Moncrief v. Martin Oil Service, Inc.*<sup>166</sup> illustrates the importance of clearly designating the location of the well if a specific location is important to the parties. In *Moncrief* Martin farmed out to Moncrief in a farmout agreement that provided that "the interest earned by operator [Moncrief] hereunder shall be in consideration for the drilling of the well on lands belonging only to Martin."<sup>167</sup> The agreement also contained a proportionate reduction clause that provided that the interest earned by Moncrief in the Martin acreage would be reduced to the proportion that the amount of the Martin acreage within the participating area for the test well bore to the total acreage within the participating area. After Martin and Moncrief executed the agreement, Martin agreed to amend it so that "if our acreage on the first Test Well does not earn your Company its full interest under the Agreement, . . . the drilling of subsequent tests can earn the interest agreed to."<sup>168</sup> Moncrief then drilled several wells, spending between \$13 and \$14 million dollars in the process. Martin refused to assign the interest that Moncrief claimed he had earned because the additional wells drilled were not located "on lands belonging *only* to Martin."<sup>169</sup> The trial court found in favor of Moncrief, the farmee, because the amending letter did not specifically embrace the requirement of the initial contract.<sup>170</sup> The appellate court upheld this position on the ground that the agreement did not require positively that subsequent tests be located on Martin's acreage, so that the trial

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Farmor; and well information, such as logs, drilling and completion reports, and engineering information.

The farmor would probably prefer to make geologic information supplied by the farmor specifically subject to a continuing confidentiality obligation of the farmee. See *infra* text accompanying notes 271-72.

164. An example of a clause specifically disclaiming any obligation of the farmor to provide geological or geophysical information follows:

Farmor shall not be required to provide farmee with any geophysical or geological information that farmor may have, and farmee shall likewise not be required to provide farmor with any such information except the information specifically set forth in § — hereof, whether such information is presently in the possession of farmor or farmee or is hereafter acquired.

165. An example of a clause permitting the farmee to select the location of the earning well follows: "Farmee's Choice: Farmee shall have the right, but not the obligation, to commence on or before \_\_\_\_\_, operations for the drilling of well (the "Initial Earning Well") at a location of Farmee's choice on the \_\_\_\_\_ of Section \_\_\_\_\_, Township \_\_\_\_\_, Range \_\_\_\_\_, \_\_\_\_\_." The discretion given the farmee will be illusory if the tract identified is small.

166. 658 F.2d 768 (10th Cir. 1981).

167. *Id.* at 769-71.

168. *Id.* at 771.

169. *Id.* at 773.

170. *Id.* at 770.

court's decision was not plain error.<sup>171</sup>

Even when the farmor and the farmee can agree that the location of the well is an essential part of their agreement, they may encounter practical problems in formulating the designation. Exact locations are hard for the farmee to satisfy and will lead to dispute. A mathematically determinable point (e.g., "the center of the SE/4 of the NW/4") may be difficult to locate when it comes time to spud the drilling rig. A general location (e.g., "within 330 feet of the center of the NW/4" or "in the NW/4") will generally be adequate to protect the interests of both parties. The farmee must satisfy itself, however, that it can meet lease restrictions and conservation agency rules by drilling in the general area identified.

Farmout agreements often provide for the initial well's location "at a legal location of farmee's choice."<sup>172</sup> This language is appropriate where the farmor's purpose is to extend the farmed-out lease. If the geological information obtained from drilling is important to the farmor, however, this language may not accomplish the farmor's goals, particularly if the tract is large. Geological information from a well drilled near the edge of the tract may not be as valuable as that from its center. A risk likewise arises that describing the location as "a legal location of the farmee's choice" will permit the farmee to earn its interest by obtaining an exception tract drilling permit<sup>173</sup> to drill close to the edge of the farmed-out acreage near a producing well outside the farmout area.<sup>174</sup>

In farmout agreements as in other contracts, a drafter should never use the phrase "at a mutually agreeable location." If the parties cannot subsequently agree upon a location, the courts will probably hold the farmout agreement to be an unenforceable agreement to agree.<sup>175</sup>

### 7. Choice of Contractors

Farmout agreements usually make drilling an option or obligation of the farmee. Since few farmees own their own drilling rigs, the parties must ordinarily contemplate that the farmee will subcontract the drilling operations. The agreement's language needs to reflect this intention by providing that the farmee "will commence or cause to be commenced actual drilling." When read with the restrictions on assignment usually included in farmout

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171. *Id.*

172. See T. FAY, *supra* note 3, at 7.

173. State oil and gas conservation agencies generally issue exception tract drilling permits either to protect correlative rights, when strict adherence to the rules would result in drainage, or to prevent waste when strict adherence would result in oil or gas never being produced. E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 79. Whether either rationale would justify issuance of a permit in the circumstance described is problematic.

174. T. FAY, *supra* note 3, at 6. Fay suggests the language used should read "at a legal location as required under the spacing requirements in effect at the time of the execution of the farmout agreement." *Id.* at 7.

175. Cf. the discussion of *Getty Oil Co. v. Blevco Energy, Inc.*, *supra* notes 78-80; see also Klein & Burke, *supra* note 3, at 494. For a discussion of the Statute of Frauds, see *supra* text accompanying notes 86-113.

agreements, the reference to "cause to be commenced" will permit the farmee to subcontract.

At least three alternatives exist to a general agreement to permit the farmee to subcontract. First, the farmor may choose the subcontractor. A farmee will rarely accept this option, however, because it will give the farmor control of a crucial provision of the agreement. Second, the farmee may select the contractor subject to certain articulated standards that the chosen contractor must meet. Third, the farmor and farmee may agree on a contractor; for example, the farmee may be given the right to choose the contractor, subject to approval by the farmor. This last alternative is acceptable only if the parties avoid the agreement to agree problem by providing that the farmor can withhold approval only for reasonable cause.

### 8. *Commencement of the Well*

Most farmout agreements specify a date by which the farmee must commence drilling in order to satisfy the agreement. If the parties anticipate title problems or if equipment appears to be in short supply, the agreement may provide for an extension of the commencement date.<sup>176</sup>

Commencement provisions vary in their terminology. Such provisions sometimes parallel those usually found in oil and gas leases and merely require that the farmee commence "operations"<sup>177</sup> or "drilling."<sup>178</sup> The requirement more frequently is that the farmee "commence the actual drilling" of a well.<sup>179</sup>

#### a. *Commencement of Operations*

When the farmee is required merely to commence operations, all that is likely to be required of the farmee is that before the date specified it do something on the farmed-out land that directly relates to or is preparatory to actual drilling.<sup>180</sup> In addition, those activities must be pursued diligently and in good faith until a well is actually spudded<sup>181</sup> and completed. This is the usual interpretation of the meaning of "commencement of operations" in an oil and gas lease.<sup>182</sup> One of the classic cases cited to support that rule involved a farmout. In *Vickers v. Peaker*<sup>183</sup> deep rights under a lease were assigned to the farmee. The assignment required that the assignee "com-

176. An example of a clause permitting extension of the commencement date follows:  
Provided, however, that the commencement date shall be extended for any period reasonably necessary for farmee to satisfy itself that title to the proposed drill site for the initial well is safe for drilling purposes and for up to thirty days in the event a suitable drilling rig is not available by the commencement date.

177. See *supra* note 165.

178. For example: "On or before \_\_, Farmee agrees to commence the drilling of a test well in accordance with all of the terms and provisions of the Agreement . . . ."

179. For example: "On or before \_\_, Farmee shall commence the actual drilling of a test well (Initial Well) at the following location: . . . ."

180. See E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 157-62.

181. "Spudding" refers to the first boring of the hole in drilling a well. 8 H. WILLIAMS & C. MEYERS, *supra* note 12, at 843.

182. *Id.*

183. 227 Ark. 587, 300 S.W.2d 29 (1957).

mence the drilling of a well" before a specified date.<sup>184</sup> The farmee, before that date, entered into a drilling contract, surveyed and cleared the location, constructed a road to the location, obtained a drilling permit, and moved material to the drill site. The drill bit did not actually pierce the earth until nearly a month after the date specified, however. The Arkansas Supreme Court held that the time of spudding was immaterial, asking the now famous rhetorical question: "Does 'baking a cake' begin with the preparation of the dough, or only with the actual placing of the dough in the oven?"<sup>185</sup> By this analysis, virtually any activity of the farmee on the land will be sufficient to commence the well properly, extend the lease, and satisfy the farmout agreement.<sup>186</sup>

### *b. Commencement of Actual Drilling*

When the farmout agreement provides that the farmee must commence the "actual drilling" of a well, however, something more is probably required. Reference to commencement of "actual drilling" is likely to require that a drill bit have pierced the ground.<sup>187</sup> A more certain variation requires that the well be "spudded" by a particular date.<sup>188</sup>

## *9. Completion of the Well*

Farmout agreements often specify, in addition to a commencement date, a date by which the earning well must be completed. The primary reason for specifying a completion date is to insure that the farmor will possess the information obtained from drilling so that it can evaluate other leases that it may have in the area. Like "commencement," the term "completion" may lead to dispute, particularly when the farmout agreement provides for the drilling of several wells, or when the farmee seeks to drill a substitute well. Two cases illustrate the point well. In *Seale v. Major Oil Co.*<sup>189</sup> a farmout agreement obligated Seale to drill two wells, the second within 45 days after "completion" of the first. Seale drilled the first well to the objective depth and abandoned it as a dry hole. He then refused to drill the second well, contending that he was unable to "complete" the first well since it was a dry hole, and that therefore he had no obligation to drill the second. The court held that the contract as a whole did not use "completion" to mean comple-

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184. 300 S.W.2d at 30-32.

185. *Id.* at 32.

186. Professor Williams summarizes the law as follows:

In brief, drilling operations may be described as any work or actual operations undertaken or commenced in good faith for the purpose of carrying out any of the rights, privileges or duties of the lessee under a lease, followed diligently and in due course by the construction of a derrick and other necessary structures for the drilling of an oil and gas well, and by the actual operation of drilling in the ground.

3 H. WILLIAMS, OIL AND GAS LAW § 618.1, at 323-24 (1986).

187. For a discussion of the federal regulations and cases interpreting "actual drilling operations," see 1 LAW OF FEDERAL OIL AND GAS LEASES § 14.05[2] (1986).

188. See T. FAY, *supra* note 3, § 2.1(b) of the farmout agreement.

189. 428 S.W.2d 867 (Tex. Civ. App.—Eastland 1968, no writ).

tion as a producing well, however, but to mean "completion of the required work on the well whether it became a producer or not."<sup>190</sup> In a recent case, *Modern Exploration, Inc. v. Maddison*,<sup>191</sup> the court interpreted a lease provision requiring the lessee to drill a well within 270 days of "completion of drilling on the first well" or lose its rights to all undrilled acreage.<sup>192</sup> The court held that "completion of drilling" was unambiguous and meant "when the well's total depth [was] reached, not when the operator [chose] to perforate the cement plug that he chose to insert into the well."<sup>193</sup>

The parties to a farmout agreement will probably have different expectations of the meaning of "completion" in different contexts.<sup>194</sup> When the farmout agreement requires the farmee to complete a well capable of producing in paying quantities in order to satisfy the agreement, as in cases when the primary purpose of the farmout agreement is to maintain a lease about to expire, "completion" probably means drilling to total depth, testing, fracturing or acidizing, and equipping the well for production. Until those steps have all been taken, the well is not capable of producing. Conversely, when the farmee can earn by merely drilling and testing, as is often the case when the primary purpose of the farmout agreement is to obtain geologic information, "completion" likely requires only that the farmee has drilled the well and performed the agreed tests.

Farmout agreements obviously should define "completion." Surprisingly, only a few of the example agreements collected do so. A draft AAPL Form provided the following definition: "A 'completed well' is a well which has been fully equipped for the taking of production, through and including the tanks for an oil well and through and including the Christmas tree for a gas well, or plugged and abandoned, as a dry hole."<sup>195</sup>

#### 10. Time Measurement

The farmout agreement's commencement and completion provisions are susceptible to disputes over the point from which time is to be measured. This appears particularly true when time is measured by reference to some other event. For example, if completion is required within "90 days after

190. *Id.* at 869.

191. 708 S.W.2d 872 (Tex. App.—Corpus Christi 1986, no writ).

192. *Id.* at 876-77.

193. *Id.* at 876. The reasoning of the court is unclear because the words just before the quoted phrase read "[c]ompletion of drilling' logically imports the time when no further drilling is needed, when oil or gas has been reached and the well is capable of producing . . . ." *Id.* The reference to "the well is capable of producing" is not the equivalent of "when no further drilling is needed."

194. *Cf. Edwards v. Hardwick*, 350 P.2d 495, 500 (Okla. 1960) (court concluded that term "completion" means well drilled to specified sand or depth, and such well so prepared for use of various methods of treatment to obtain production of oil and gas).

195. AAPL draft Form 635, § 2(a) (Kraftbilt, Tulsa 1987). The quoted provision is appropriate for a "produce to earn" farmout. Another phrasing of the provision could read: "'Completion' means the point at which testing is completed as required in order to receive a production allowable from the Texas Railroad Commission." For a "drill to earn" farmout, the following phrasing might be appropriate: "'Completion' of a well for the purposes of this Agreement shall be defined as the release of the completion rig, if the well is completed for production, or release of the drilling rig, if the well is plugged and abandoned."

commencement of drilling," the parties may not agree either when particular actions were taken or whether those actions were sufficient to commence drilling. Provisions that the farmee must commence actual drilling "90 days after acceptance of this offer" or exercise its option for a substitute well "within 60 days after release of the drilling rig" may also lead to factual disputes as to when acceptance occurred or the rig was released.

Measuring time by reference to events may lead to disputes as to how the parties are to count days. An accepted principle of general contract law holds that the day a contract is executed is not counted in measuring time, while the party required to perform has until the end of the last day to perform.<sup>196</sup> Only a few cases apply that principle to oil and gas leases, however.<sup>197</sup> In the interests of certainty, a specific calendar date is preferable, whether the parties are referring to commencement or completion of the well. If the farmout agreement specifies a calendar date, the farmee must be careful that the date inserted is reasonable. By the time negotiations are completed, the date provided for, even if reasonable when the parties began negotiating, may no longer provide the farmee adequate time to perform.

Farmout time measurement issues are made more important by "time is of the essence" provisions found in most farmout agreements. In Texas one court has held that commencement of drilling operations in a timely manner under an operating agreement was not essential to maintaining the agreement because nothing in the agreement indicated that the parties intended it should be.<sup>198</sup> A different result probably would be reached under most farmout agreements, however, either because time is specifically made of the essence<sup>199</sup> or because the agreement requires absolute performance of all of the terms and conditions of the agreement for the farmee to earn.<sup>200</sup> All but a small percentage of the example agreements collected contained one or the other of these clauses, and some contained both. An alternative to providing for specific time periods is to require "diligent operations" or "diligent and continuous operations." The opportunities for disagreement as to the meaning of those terms are obvious, however.

## 11. *Objective Depth*

### a. *Footage vs. Formation*

The "objective depth," or the "contract depth" as it is sometimes called, is the depth that the farmee must drill under the terms of the farmout agreement in order to earn its interest under the farmout agreement. Objective

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196. See *Columbia Pictures Corp. v. DeToth*, 26 Cal. 2d 753, 161 P.2d 217, 220 (1945); *Pitcock v. Johns*, 326 S.W.2d 563, 565-66 (Tex. App.—Austin 1959, writ ref'd).

197. See, e.g., *Winn v. Nilsen*, 670 P.2d 588, 590 (Okla. 1983).

198. *Argos Resources, Inc. v. May Petroleum, Inc.*, 693 S.W.2d 663, 665 (Tex. App.—Dallas 1985, writ ref'd n.r.e.). But see *United Carbon Co. v. Monroe*, 92 F. Supp. 460, 465 (W.D. La. 1950), holding that time is implicitly of the essence in drilling contracts, presumably including farmout agreements.

199. An example of a "time is of the essence" clause is: "Time is of the essence to this agreement and to all its terms and conditions."

200. See *infra* note 261.

depth usually is described either by reference to the number of feet to be drilled or by description of the formation to be explored. Either may cause interpretive difficulties.

*i. Footage*

The farmout agreement sometimes will describe the objective depth by the feet to be drilled. For example, the farmor and the farmee may agree that the farmee will drill the test well to 5,000 feet. A footage description of objective depth is inherently flawed, however, unless the agreement also addresses how footage is to be measured. No industry custom or usage exists. The intention of the parties may be that the reference be to measured depth, the distance down the hole actually drilled, which can be determined by measuring the drill pipe utilized. This method is probably the easiest. The reference to footage, however, may also refer to the vertical depth. Vertical depth will be different from measured depth, because inevitably the hole drilled will deviate somewhat from the perpendicular.

Even if the parties plainly intended the footage reference to refer to measured depth or to vertical depth, ambiguities remain as to how to determine those depths. Is the reference to objective depth, the deepest point reached by drilling, or to completion depth, the depth to which the well is plugged back for testing and a completion attempt? Furthermore, from where is the depth to be measured? It will make a difference whether the starting point for measurement is the kelly bushing,<sup>201</sup> the surface, or sea level.

There are relatively few disagreements over how to measure footage. The farmor and the farmee usually have an unspoken or oral understanding as to how to make the measurement. The lawyer drafting or reviewing a farmout agreement should not rely upon the innate desire of the parties to get along, however. The agreement itself should define how to measure the footage.

*ii. Formation*

A second method of describing the objective depth in a farmout agreement is to refer to a formation that the farmee will test or to one in which a well is to be completed. A common formulation states that "farmee agrees to drill . . . to a depth sufficient to adequately test the \_\_\_\_\_ formation . . ." <sup>202</sup> An objective depth described by reference to the formation to be tested is more common than one described by footage. The farmor may not be certain that the information or production that it wants can be developed within a footage limitation, since geologic formations are often tilted or broken. On the other hand, the farmee will not want to be obligated to waste money by drilling deeper than is necessary to test or to obtain production. Therefore, unless the farmor and farmee are certain that the farmee will find

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201. The kelly bushing is a device fitted to the floor of the drilling platform through which passes the steel pipe that transmits torque from the rotary table to the drill string and rotates the drill bit. S. PALMER, *PETROLEUM INDUSTRY GLOSSARY* 109 (1st ed. 1982).

202. When drilling in an unexplored area, the reference may be "to the basement rock," if a specific objective formation cannot be identified.

their objective at a particular depth, description of the objective depth by reference to the formation to be tested will be the favored method.

Description of the objective depth by formation may also lead to misunderstandings. There may be ambiguity as to what the formation is called. The same formation may have different names even in the same general area. Similar names may describe very different formations. Even if there is no ambiguity as to the formation to be tested, recognizing it when it is found may be difficult. The same formation may have different lithological characteristics in different areas.<sup>203</sup> In addition, a formation may be broken or overthrust, so that it is found at several widely separated depths in the same area.

The solution to these problems again is precise drafting. A drafter may minimize problems in recognizing the formation by referring (1) to a "control well," another well that has tested the formation sought,<sup>204</sup> or (2) to a description of the formation published by a state or federal geological surveyor or bureau of mines. A description of the formation to be drilled and tested may also be combined with footage limitations. This device avoids dispute and limits the farmee's obligation in case the formation is encountered at substantially different depths.<sup>205</sup> Such a combination is probably the most frequently used method of describing the objective depth.

#### *b. Standard of Testing*

The farmout agreement's clause describing the objective depth often requires that the objective depth be tested "to the farmor's satisfaction."<sup>206</sup> The courts would impose a standard of reasonableness upon the farmor.<sup>207</sup> The farmee would clearly prefer, however, that the agreement express the standard of testing by what the reasonable, prudent operator would do under the circumstances or "to the farmee's satisfaction."

#### *c. What About Shallow Production?*

A recurring problem in farmout agreements is determining the rights of the parties if the farmee encounters production in a formation at less than the objective depth. There are at least three possible solutions. The agreement may require the farmee to drill to and test the objective depth notwithstanding the shallow discovery. Completion of a shallow well, perhaps with limitations imposed upon the depth earned, may satisfy the objective depth

203. Lithology is the study of rocks. WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 698 (9th ed. 1985). Geologists often describe rocks by their overall physical characteristics, which they refer to as their "lithological characteristics."

204. Note, however, that if the control well is a substantial distance from the well to be drilled, the farmout earning well may not encounter the formation tested by the control well.

205. A provision in the farmout agreement may state, for example, that "[t]he Test Well will be spudded by Farmee on or before \_\_\_\_\_ and will be drilled to a true vertical depth of \_\_\_\_\_ feet below the surface or \_\_\_\_\_ feet below the bottom of the \_\_\_\_\_ formation, whichever is less . . . ."

206. See *infra* note 261.

207. A fundamental principle of contract interpretation applied by courts is the standard of reasonableness. E. FARNSWORTH, CONTRACTS 492 (1982).

provision.<sup>208</sup> Finally, production from the shallower depth may satisfy the objective depth of the requirement if the farmee tests the objective depth or drills a substitute well.

*d. What About Drilling Deeper?*

Farmout agreements less frequently address whether the farmee can drill deeper than the objective depth. The farmee may want to drill deeper because geological information obtained in drilling the well suggests that the productive formations will not be found where they were expected. Geologic information may indicate that deeper drilling will result in better production.

Again, there are at least three options. The farmor, which is entitled to all drilling information, may prefer to keep deeper rights. Second, the farmor may allow the farmee to drill deeper only if the farmee tests the objective depth as well as the deeper formation,<sup>209</sup> or if the farmee later drills a substitute well to test the objective formation. Finally, the agreement may give the farmee an option to drill a deeper well after a test of the objective formation.<sup>210</sup> Whatever is the intent of the parties, the agreement should be specific.

*12. Produce to Earn or Drill to Earn*

What the farmee has to do to earn its interest under the farmout agreement is a key characteristic of the agreement,<sup>211</sup> as has been discussed above. The farmee's obligations also present substantial interpretative and drafting

208. An example of a clause permitting the farmee to complete in a shallower formation than the objective depth is:

If during the drilling of the Earning Well, operator shall encounter what it believes to be potential production in a zone encountered at a depth shallower than Contract Depth, then if operator elects not to drill deeper, operator may test and/or make a completion attempt in such shallower zone. For the purposes hereof, such shallower zone shall be deemed to be a Contract Depth and thereby fulfill the drilling commitment created hereby.

209. For example, the following language specifically permits the farmee to drill beyond the objective depth.

Farmee shall drill the Earning Test Well to a depth sufficient to thoroughly test the \_\_\_\_ formation, or to a maximum depth of seven thousand three hundred (7,300) feet below the surface, whichever is the lesser depth; *provided that nothing contained in the foregoing shall prevent Farmee from drilling to such deeper depth below the provided depths as Farmee may elect.*

(Emphasis added.)

210. An example of a clause giving the farmee an option to drill a deeper well after completing a well in the objective formation is:

Farmee shall have the option for a period of \_\_ days after the release of the drilling rig from the initial well to drill any well on the subject lands to any depth deeper than the depth drilled in the initial well. In the event that farmee exercises its option and drills a well to such deeper depth, farmor shall, subject to the other provisions of this agreement, grant to farmee the leasehold interest in the lands subject to this agreement to a depth of 100 feet below the stratigraphic equivalent of the total depth reached in such deeper drilling.

211. See *supra* text accompanying notes 138-41.

problems. These problems are somewhat different in produce to earn farmouts than in drill to earn farmouts.

*a. Produce to Earn Farmouts*

The primary problem with produce to earn farmouts is in the choice of language used to express the production requirement. Some farmouts require merely a capability of "production."<sup>212</sup> Others require capability of "production in paying quantities"<sup>213</sup> or "production in commercial quantities."<sup>214</sup>

The meaning of such terminology is not precise. In the context of oil and gas leases, courts have reached a variety of interpretations of similar terms. For example, courts have held that the term "commercial quantities" requires that operating revenues be greater than operating costs,<sup>215</sup> that there be production merely "of sufficiently large amount to be sold by the owner to a buyer for transport elsewhere,"<sup>216</sup> or that there be a probability that the revenues of offset wells will pay back the cost of their drilling plus a profit.<sup>217</sup> "Paying quantities" is also a term that may have different meanings in different contexts. When the issue is whether a lease is maintained by marginal production, "paying quantities" generally requires merely that the revenues from production exceed operating costs.<sup>218</sup> When the issue is whether the lessee owes the lessor a duty to develop or to protect against drainage, the term generally requires that the probable revenues from drilling pay the costs of drilling, completing, and operating, and return a reasonable profit.<sup>219</sup>

Each of these definitions may be appropriate in a produce to earn farmout. The meaning of the terms may differ according to the circumstances in which they are used. When the farmout's purpose is lease maintenance, the

212. For example: "If the Test Well is commenced and thereafter drilled to Contract Depth and completed and equipped for *production* in accordance herewith, Farmor will assign to Farmee . . . ." (Emphasis added.)

213. For example:

In the event you are successful in completing a well or wells capable of producing oil or gas in *paying quantities* on said land and in compliance with all of the terms and conditions hereof, then farmor, upon your written request, shall execute and deliver to you an assignment of its rights, title, and interest in and to all of the oil and gas held under said lease in and to each governmental proration unit of said land upon which you finally complete a well capable of producing oil or gas in paying quantities . . . .

(Emphasis added.)

214. See *Landauer v. Huey*, 143 Colo. 76, 352 P.2d 302, 308 (Colo. 1960); see also ¶ 2 of the farmout agreement attached at Scott, *supra* note 3, at 84.

215. *Texaco, Inc. v. Fox*, 228 Kan. 589, 618 P.2d 844, 847 (1980) ("commercial quantities" synonymous to "paying quantities" for purposes of maintaining lease in secondary term).

216. *State v. Wallace*, 52 Ohio App. 2d 261, 369 N.E.2d 781, 785 (1976) (issue was propriety of plugging order of state conservation agency).

217. *Pan Am. Petroleum Corp. v. Shell Oil Co.*, 455 P.2d 12, 14-17 (Alaska 1969) (issue was whether blowout constituted "discovery in commercial quantities" so that lessee of state lease became entitled to pay reduced royalty rate).

218. *Clifton v. Koontz*, 160 Tex. 82, 90-92, 325 S.W.2d 684, 690-92 (1959).

219. See 5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 58.3 (1964) (discusses appropriate cases).

agreement serves that purpose so long as operating revenues are greater than operating expenses over a reasonable time.<sup>220</sup> When the purpose of the farmout is to satisfy an obligation of the farmor to drill an offset, development, or exploratory well, drilling and attempting to complete satisfy the obligation, so that any production should be sufficient to earn. When the purpose of the farmout is to obtain exploration of its leases, discovery of a formation that will permit the drilling and profitable operation of additional wells may well be the intent of the parties. In addition, a case can be made that the parties intend that rights will be earned under a produce to earn farmout only when a well is drilled and completed capable of producing enough to pay costs of drilling, completing, and operating, plus a reasonable profit; this makes sense, for example, when joint development of a field or dedication of reserves is the business purpose of the farmout agreement.

The first definition of production is the one most likely to be intended by farmor and farmee, because it is the definition generally used in leases. It therefore comes to mind first. In addition, the most common reason for a farmout agreement is lease maintainence. Often, however, the terms of the agreement suggest nothing about the intent of the parties. To avoid ambiguity and dispute, the parties should carefully define whatever term is used to describe "produce to earn."

#### *b. Drill to Earn Farmouts*

Parallel interpretative problems arise with drill to earn farmout agreements. The term "drill," whether couched as a covenant or a condition, may require drilling to an objective depth and testing the formation found. For example, that may be the parties' intent when the farmout's purpose is to drill a court-ordered "obligation" well to satisfy an implied covenant to develop or to protect against drainage. The same term may require only drilling to the objective depth, with a decision at the casing point<sup>221</sup> to test or not,<sup>222</sup> when the purpose of drilling is to satisfy an implied covenant to drill an exploratory well. A case may even be made that the farmor and the farmee intend that the drill to earn farmout be satisfied when the farmee has timely commenced in good faith and diligently pursued drilling operations, even though the objective depth is never reached. Such a definition would be appropriate, for example, when a court order is satisfied if impenetrable substances or conditions are encountered that make abandonment necessary. Again, specificity is the watchword for the drafter.

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220. As long as operating revenues are greater than operating expenses, the underlying lease is maintained. J. LOWE, *supra* note 9, at 176.

221. The casing point is the point where "a well has been drilled to the objective depth stated in the initial notice, appropriate tests have been made" and a decision is to be made whether to complete it and equip it for production. 8 H. WILLIAMS & C. MEYERS, *supra* note 12, at 109.

222. For an example of the type of agreement, see *Modern Exploration, Inc. v. Maddison*, 708 S.W.2d 872, 875-76 (Tex. App.—Corpus Christi 1986, no writ), discussed *supra* text accompanying notes 191-93.

### 13. Performance as an Option or Obligation

As discussed above, whether performance of the farmout provisions is the farmee's option or obligation is one of the key characteristics of the farmout agreement.<sup>223</sup> In addition, that choice presents significant problems for the lawyer drafting or reviewing the agreement. The problems begin with classification of language in farmout agreements.

#### a. Classification Problems

Classification of farmout language as making drilling a covenant to perform or a condition of earning may be difficult. Many drafters word farmout provisions relating to commencement of initial drilling as a covenant, but then follow with language that transforms the obligation to drill into a mere condition of earning.<sup>224</sup> One must read the agreement as a whole to determine whether drilling is an option, an obligation, or a bit of both.<sup>225</sup>

223. See *supra* text accompanying notes 133-37.

224. Lamb, *supra* note 3, at 154. One example agreement provides:

2. *Initial Test Well.* On or before \_\_\_\_\_, Farmee shall commence or cause to be commenced the actual drilling with suitable rotary equipment of a well . . . and shall thereafter continuously prosecute such drilling operations in a diligent and workmanlike manner until the well reaches a depth sufficient in Farmor's judgment to test \_\_\_\_\_.

\* \* \*

12. *Failure to Drill.* Farmee shall not be liable in damages to Farmor for failure to commence, drill, test, complete or equip the Initial Test Well as herein provided, but any such failure shall result in the loss to Farmee of all rights under this agreement. The foregoing shall not be construed to preclude or limit any rights Farmor may have in law or in equity, by virtue of Farmee's negligence or willful misconduct, or for any breach by Farmee of any other obligation under this agreement (including, without limitations, the obligations to provide information to Farmor and to indemnify Farmor as hereinafter provided).

Scott, *supra* note 3, at 83, 87. The last sentence of the quoted ¶ 12 makes that paragraph something less than a complete release of the farmee from liability, however. The farmee does not have to drill under the example language, but if the farmee does drill, it must comply with the contractual provisions or face liability. See *infra* text accompanying note 229.

225. For example, the language following makes drilling a clear-cut obligation:

Farmee shall drill a well, hereinafter called the Earning Well, strictly in accordance with the following well specifications:

- (a) Location: \_\_\_\_\_
- (b) Spudding Deadline: \_\_\_\_\_
- (c) Required Depth: \_\_\_\_\_
- (d) Completion/Plugging Deadline: \_\_\_\_\_

The obligations of Farmee hereunder are firm obligations and covenants as well as conditions to earning the assignment(s) provided for.

In contrast, the following language indicates that drilling is a condition for earning, and that a failure to drill will not result in liability:

"Farmee shall have the option, but not the obligation, to drill a well at the location designated below and thereby earn the rights set forth below to the leases described at Exhibit \_\_\_\_, all subject to the terms, limitations and conditions set forth below."

The possibility exists to make commencement of drilling an option, but to make completion of a well commenced an obligation. For example:

If the test well is commenced, farmee agrees to drill the test well to a depth at which the \_\_\_\_\_ formation has been properly tested therein or to a depth of \_\_\_\_\_ feet, whichever is first reached (objective depth) and to complete the test

*b. Option to Drill*

When the farmout agreement gives the farmee an option to drill, difficult practical and conceptual problems arise. For the farmor, one problem is whether the farmee that has commenced drilling may choose to forfeit its right to earn under the farmout agreement in order to avoid sharing valuable information obtained in its drilling operations.<sup>226</sup> If drilling truly is an option, the farmee presumably may choose to abandon operations at any time and for any reason.<sup>227</sup> The abandonment provisions of the farmout, which typically give the farmor the right to take over drilling operations, may minimize this problem.<sup>228</sup> Releasing the farmee from liability for not drilling, but specifically providing for liability for failure to provide promised information, may also solve the problem.<sup>229</sup>

*c. Obligation to Drill*

When dealing with a farmout agreement that makes drilling the farmee's legal obligation, the issue of liability for failure to perform is of crucial importance to both farmor and farmee. There is a split of authority as to the measure of damages for breach of an express promise to drill. In a majority of states, including Oklahoma and Louisiana, the remedy is apparently the cost of drilling the promised well.<sup>230</sup> In a minority of states, including Texas, the remedy is the benefit that the one party would have received had the other drilled the well as promised.<sup>231</sup> That remedy may be the "lost royalty," which is defined as the royalty that would have resulted had the well been drilled as promised.<sup>232</sup> Other available measures of damages in-

well for production or plug and abandon the well as a dry hole, in full compliance with the terms and provisions of section \_\_ below.

226. Hardwick, *Operational Agreements in the Shadow of Bankruptcy—What Can Be Done to Structure Agreements in Order to Minimize the Problems of a Party that Later Goes Bankrupt*, 1986 ROCKY MTN. MIN. L. SPEC. INST. ON PROBLEMS AND OPPORTUNITIES DURING HARD TIMES IN THE MINERALS INDUSTRY 6-1, 6-2.

227. *Id.*

228. See *infra* note 357.

229. See *supra* note 224.

230. *Fite v. Miller*, 196 La. 876, 200 So. 285, 286 (1940); *Ardizonne v. Archer*, 72 Okla. 70, 178 P. 263, 265-66 (1919). These cases, like most of those cited in this article, deal with breach of a drilling covenant in a lease. Professors Williams and Meyers have asserted, however, that the problems are the same in the context of breach of a farmout as they are in breach of a lease, so that the rules should be the same. See 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 432.2 (1985). Professors Williams and Meyers also cite cases from the federal courts, as well as courts in Colorado, Kansas, and Montana, as adopting the cost of drilling rule. 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 885.1 (1985).

231. See, *Guardian Trust v. Brothers*, 59 S.W.2d 343, 345 (Tex. Civ. App.—Eastland 1933, writ ref'd). Professors Williams and Meyers cite cases from the federal courts, as well as from courts in California, Alberta, and Kentucky, as adopting the lost royalty rule. See 5 H. WILLIAMS & C. MEYERS, *supra* note 230, § 885.2. See also *Stinnett v. Damson Oil Corp.*, 813 F.2d 1394 (9th Cir. 1987) (a recent case applying the rule).

232. For an excellent analysis and collection of the cases dealing with the measure of damages, see Annotation, *Right and Measure of Recovery for Breach of Obligation to Drill Exploratory Oil or Gas Wells*, 4 A.L.R.3d 284 (1965). In *Guardian Trust* a Texas court of civil appeals reasoned, "The true and ultimate purpose of all parties to the lease was 'the mutually profitable production of oil, gas or other valuable mineral.'" 59 S.W.2d at 345 (citation omitted). The court concluded, therefore, that the lost royalty was the appropriate measure of damages,

clude the value of the retained interest<sup>233</sup> or the value of the information that drilling would have developed.<sup>234</sup>

The Texas rule that the remedy for the breach of an express promise to drill is the value of the performance to the obligee is better law than the majority rule.<sup>235</sup> The Texas rule places a heavy burden of proof upon the farmor whose farmee has failed to perform, however. *Martin v. Darcy* is a case in point.<sup>236</sup> In that case Martin promised to drill a well under an assignment of a farmout from Darcy but failed to do so, though the well was later drilled and completed as a dry hole by another. Darcy sued and recovered \$3000 on the theory that the interest that he had retained had possessed a market value of \$6000 and that he would have sold half of it before completion of the well had Martin drilled it. The appellate court reversed the award on the basis that to recover Darcy would have had to have shown (1) that the profits he claimed had been contemplated by the parties when the agreement was made and (2) that he actually would have sold his interest.<sup>237</sup> The problem, as the court in *Martin v. Darcy* noted, is that at the time the farmout is negotiated no one knows what the farmor will do with its interest, including the farmor. Therefore, at least the second element of proof required to establish a basis for recovery of damages can rarely be proved.<sup>238</sup>

Because of the difficulty in a state like Texas of proving actual damages for breach of a farmout agreement obligating the farmee to drill, the parties may include a stipulation of liquidated damages in the agreement.<sup>239</sup> It is difficult

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noting that the cost of drilling would be inappropriate because such a measure is not the value of performance to the obligee but "the cost of performance by the obligor." *Id.* at 346. The "lost royalty" rule is not rigidly applied, however:

After an early adoption of the cost of drilling as the measure of damages, the Texas courts have apparently rejected any mechanical application of that rule and have now adopted a flexible test under which the plaintiff is entitled to recover the value of the performance of the contract to him, such value to be determined in the light of the peculiar facts of each case.

Annotation, *supra*, at 299 (footnotes omitted).

233. See *Martin v. Darcy*, 357 S.W.2d 457, 459-60 (Tex. Civ. App.—San Antonio 1962, writ ref'd n.r.e.); see also 5 H. WILLIAMS & C. MEYERS, *supra* note 230, § 885 (discusses other measures of damages). A value of retained interest measure would be particularly appropriate, in the author's view, in a "lease salvage" type farmout.

234. See *Atlantic Oil Prod. Co. v. Masterson*, 30 F.2d 481, 482 (5th Cir. 1929). Using the value of the information that was to have been obtained would be particularly appropriate in what the author calls an "exploration and evaluation" farmout.

235. The Texas rule is "better" law because it is the usual rule for recovery of damages for breach of contract. *Hadley v. Baxendale*, 9 Exch. 341, 26 Eng. L. & E. 398 (1854). In fact, *Hadley v. Baxendale* formed the basis of the decision in *Whiteside v. Trentman*, 146 Tex. 46, 170 S.W.2d 195 (1943).

236. 357 S.W.2d 457 (Tex. Civ. App.—San Antonio 1962, writ ref'd n.r.e.).

237. *Id.* at 460.

238. *Id.* A detailed statement of the purpose of the farmor in entering into the farmout would help significantly in meeting the burden of proof. See *supra* text accompanying notes 123-24.

239. An example of a liquidated damages clause is: "FAILURE TO DRILL; DAMAGES. If farmee fails to drill the test well as required by § \_\_\_\_, farmee shall pay to farmor on or before \_\_\_\_, \_\_\_\_ dollars (\$ ) which shall be deemed farmor's liquidated damages arising out of farmee's failure to perform." In the author's opinion, the more detail included, the better the agreement.

to draft a liquidated damages clause with certainty that it will be enforced, however.<sup>240</sup> Of particular concern in drafting liquidated damages provisions in farmout agreements is the need when setting damages to take into account the extent of performance. The extent of performance would be important in determining actual damages, and stipulated damages might not be awarded if they grossly exceed actual damages.<sup>241</sup> An agreement to pay the estimated cost of drilling an obligation well, therefore, probably would be classified as an unenforceable penalty when the breach occurs after drilling to the casing point.

Other alternatives for the farmor worried that a farmee will fail to perform a farmout agreement drafted as a covenant to drill include obtaining security for performance, escrow of drilling funds, and requiring a performance bond.<sup>242</sup> However, negotiating any of these is likely to complicate forming the agreement. Furthermore, it is an axiom of the industry that when performance guarantees are necessary, they are unobtainable.

#### 14. *The Substitute Well Clause*

Another axiom of the oil and gas industry is that "if something can go wrong, it will go wrong." That maxim particularly applies to well drilling, especially drilling exploratory wells. Mechanical breakdowns are almost in-

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240. Agreements for stipulated damages are enforceable if courts determine such damages to be estimated compensation for injuries, but not if courts classify them as penalties. Courts have often said that the distinction between a penalty and liquidated damages is that a penalty is not a measure of compensation for breach, but a security for actual damages. *See, e.g.*, *Gregory v. Nelson*, 147 Kan. 682, 78 P.2d 889, 892 (1938); *Jones v. Mays*, 248 S.W. 129, 130-32 (Tex. Civ. App.—Austin 1923, writ *dism'd*); *Bourland v. Huffhines*, 244 S.W. 847, 848-52 (Tex. Civ. App.—Amarillo 1922, writ *dism'd*). To be enforceable, a liquidated damages provision must meet two requirements. First, the court must find that the amount of damages to be reasonably anticipated would be difficult to ascertain because of uncertainty or indefiniteness. The contract provision should contain a specific statement of agreement of the parties to this effect. Second, the stipulated amount must be either a reasonable estimate of probable damages or reasonably proportionate to actual damages.

241. *Stewart v. Basey*, 150 Tex. 666, 245 S.W.2d 484, 486 (1952) ("The universal rule for measuring damages for the breach of a contract is just compensation for the loss or damage actually sustained. . . . A party has no right to have a court enforce a stipulation which violates the principle underlying that rule.").

242. An example of a clause requiring a surety bond to guarantee performance of farmout agreements follows:

You agree to deliver to farmor a bonded form attached hereto as Exhibit — executed by you as Principal and by a corporate surety acceptable to farmor. In the event you should fail to comply with the obligations contained in this farmout agreement to pay all persons who furnish labor or material for use in or in connection with the drilling of the initial or any subsequent test well hereunder, or fail to prevent the filing of liens against the leasehold estate subject hereto, then you and the surety on your bond shall be jointly and severally liable to farmor in the amount of \_\_\_\_\_ payable forthwith upon such default at \_\_\_\_\_. Upon your completion of the initial test well and all subsequent test wells, if any, at the location, within the time, in the manner and to the depth specified and upon your furnishing to farmor evidence, satisfactory to it, that all persons have been paid for labor performed or material furnished in connection with or in the actual drilling of such well(s) and that there are no other claims for damages or liens of whatsoever nature against the above described leases resulting from the drilling of such well(s), you and your surety shall be discharged from any obligation thereunder.

evitable. No matter how thorough and professional the geologic and geophysical analysis, there is always a risk of encountering unexpected conditions or impenetrable formations. Farmout agreements, therefore, almost always contain a substitute well clause that sets forth circumstances that excuse the farmee from drilling the earning well and give it the right to drill another earning well.

*a. Escape Provisions*

When the agreement obligates the farmee to drill the well, both parties will be vitally concerned with the escape provisions—the terms of the substitute well clause that set out the circumstances in which the farmee may abandon its drilling operations.<sup>243</sup> Without such provisions, the farmee that fails to perform covenanted drilling operations may be liable. Even if drilling under the farmout is merely an option of the farmee, the escape provisions of the substitute well clause are important. The farmee that fails to drill an option well will lose its rights to earn under the farmout, unless the escape provisions provide for a right to drill a substitute well.

Escape provisions vary widely. Some farmouts excuse performance where “igneous rock or other impenetrable substances are encountered at a lesser [than the objective] depth.”<sup>244</sup> Others let the farmee escape its obligations

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243. The escape provisions of the substitute well clause must be read in conjunction with the force majeure clause, if any, in the farmout agreement. A force majeure clause may broaden the circumstances under which a party may excuse a failure to perform. For example, the following clause is substantially broader than most substitute well clause escape provisions:

If Farmee is rendered unable, wholly or in part, by force majeure to carry out its obligations or to meet its deadlines under this agreement, other than the obligation to make money payments, it will give to Farmors prompt written notice of the force majeure with reasonably full particulars concerning it; thereupon, the obligations or deadlines of Farmee, insofar as they are affected by the force majeure, shall be suspended during, but no longer than, the continuation of the force majeure. Farmee shall use all reasonable diligence to remove the force majeure as quickly as possible.

The requirement that any force majeure shall be remedied with all reasonable dispatch shall not require the settlement of strikes, lockouts or other labor difficulty by Farmee contrary to its wishes; how all such difficulties shall be handled shall be entirely within the sole discretion of Farmee.

The term “force majeure” as employed herein shall mean an act of God, strike, lockout or other industrial disturbance, act of the public enemy, war, blockade, public riot, lightning, fire, storm, flood, explosion, governmental restraint, governmental inaction, nonavailability of drilling equipment or other equipment or personnel, and any other cause whether of the kind specifically enumerated or otherwise, which is not reasonably within the control of Farmee.

The following is a farmout force majeure clause keyed to the force majeure clause of the underlying oil and gas lease:

*Force Majeure*—any obligation of a party to this Agreement shall be suspended, and any time deadline provided in this Agreement shall be extended, for any period during which performance of such obligation or the meeting of such deadline shall be prevented by the occurrence of any force majeure circumstance. For purposes of this paragraph, a “force majeure circumstance” shall mean any of the events described in paragraph \_\_\_ of the Oil and Gas Lease attached hereto as Exhibit \_\_\_. The party affected by a force majeure circumstance shall give notice to the other party the occurrence of such circumstance and shall take all reasonable action to remove such force majeure circumstance.

244. *R. Olsen Oil Co. v. Fidler*, 199 F.2d 868, 869 (10th Cir. 1952).

when it encounters "a formation or other physical condition in the well which renders further drilling impracticable."<sup>245</sup> The agreement sometimes spells out what will render the drilling impracticable.<sup>246</sup>

Farmout escape provisions are often vague and ill-defined because the parties are attempting to provide for the unknown. Strictly speaking, for example, no substance is "impenetrable."<sup>247</sup> One should note, however, that the focus of most formulations is upon physical conditions in the hole<sup>248</sup> or mechanical difficulties not caused by the farmee's negligence. The cost of conducting operations, the farmee's economic circumstances, or market conditions do not generally provide a basis for escape from a drilling obligation.<sup>249</sup>

The parties may negotiate broad escape provisions to relieve the farmee from a drilling obligation or to preserve its right to drill substitute option wells. Escape provisions may take into account the costs of drilling,<sup>250</sup> time expended,<sup>251</sup> technology,<sup>252</sup> or make reference to what the reasonable, prudent operator would do in the circumstance.<sup>253</sup> Indeed, it is common for

245. See Scott, *supra* note 3, at 83. One commentator has described any language that refers to impracticality or defines impracticality as a "Gulf Coast Clause." See Glass, *supra* note 3, at 6. "Impractical" and "impracticable" are apparently used interchangeably in such clauses. It is not clear to me that they have precisely the same meaning; they do not in plain English.

246. For example:

loss of circulation, partial loss of circulation, water flow, domal formation, abnormal pressures, heaving shale, or similar formation, salt or other similar condition, is encountered which makes drilling abnormally difficult or hazardous, causes sticking of drill pipe or casing, or other similar difficulty which precludes drilling ahead under reasonably normal procedures . . . .

Another example makes drilling impracticable when drilling gets "to such lesser depths at which pressures are encountered which would cause a reasonable prudent operator to require the utilization of a mud weight of 16.0 pounds per gallon or greater . . . ."

247. At least one commentator has said flatly of "impenetrable substances" that "I am uncertain as to its meaning." Lamb, *supra* note 3, at 157.

248. In *R. Olsen Oil Co. v. Fidler*, 199 F.2d at 870, the court defined the phrase "igneous rock and other impenetrable substances" as used in farmout agreements in New Mexico and Oklahoma to mean "to reach a geological formation . . . which, in the business of production of such minerals, it is recognized will reasonably preclude the probability of finding oil or gas in or below such formation." (Emphasis in original.)

249. John Scott, however, notes that drafters of escape provisions often do not refer to physical conditions in the hole and that such formulations may arguably be stretched into broad force majeure clauses. Scott, *supra* note 3, at 83 n.33.

250. For example: "If in drilling . . . a condition or formation is encountered which renders further drilling impracticable for the reason that the cost per foot of such further drilling would be in excess of 150 percent of the cost per foot anticipated in the AFE . . . , Farmee may cease drilling operations . . . ."

251. What some have called a "72 hour continuous efforts" clause will permit the farmee to cease operations if it has made a good faith continuous effort for 72 hours to solve the problem. L. MOSBURG, *supra* note 3, § 3.03.

252. For example:

Operator shall use its best efforts to drill or cause to be drilled the earning well to be situated on a drilling unit comprising a portion of the contract lands, and which well shall be drilled to (i) Contract Depth or (ii) a depth where there is encountered a practically impenetrable substance making further drilling in light of existing technology impossible or impracticable.

253. For example:

If, in the drilling of the initial test well, operator encounters a drilling condition

option farmouts to provide that the farmee can abandon drilling of the initial well "for any reason."<sup>254</sup>

While the use of general terms in drafting escape provisions is probably unavoidable because of the uncertainties inherent in drilling, the parties should be as specific as possible. When the farmor and the farmee have established a working relationship in prior dealings, the farmor may agree to escape provisions that give the farmee substantial discretion. When the parties have no prior relationship, or when the farmor's experience with the farmee suggests that the farmee is inefficient or untrustworthy, the parties should state objective criteria. Both the drafter and his client must recognize, however, that even specifically enumerating the circumstances that will excuse the farmee from drilling will not preclude factual disputes over whether or not the enumerated circumstances have occurred.

*b. Substitute Well Provisions*

*i. Option or Obligation*

The initial issue in any substitute well clause is whether drilling a substitute well is an option or an obligation. If the initial well is an obligation of the farmee, the farmor will probably wish to make the substitute well an obligation. The factors that led the farmor to bargain for a covenant to drill are likely still to apply if the farmee abandons the initial attempt. The farmee, on the other hand is likely to want an option to walk away from the deal if its efforts and expenditures have been unsuccessful, at least unless it has reason to believe that the same circumstances will not arise in drilling a second well.

Most farmout agreements make a substitute well an option, even though the parties structure the drilling of the earning well as a covenant of the farmee. An alternative is to make drilling the substitute well an obligation of the farmee unless there are reasonable grounds to believe that conditions similar to those that caused abandonment of the earning well will also arise in drilling the substitute well.<sup>255</sup>

*ii. Well Details*

The agreement should also address the requirements of drilling operations for a substitute well. In providing for a substitute well's commencement date, the parties must take into account the termination date of the lease farmed out. They must also allow for the practical problems of arranging to drill; typically farmers and farmees agree to allow 60 to 90 days. If the

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or substance before reaching the above specified depth or formation which cannot be overcome by means or methods customarily used by prudent operators in the area, then and in such event, the test well may be plugged and abandoned at the depth at which the substance or condition is encountered and operator is hereby granted and given an option to commence and drill a substitute well for said well.

254. Glsas, *supra* note 3, at 6.

255. L. MOSBURG, *supra* note 3, at 186-88.

agreement provided a completion deadline for the earning well, the parties will need to modify that date appropriately for a substitute well.

The location of the substitute well is likely to be a troublesome matter. If adverse conditions encountered in drilling were the farmor's reason for abandoning the initial well, it is likely that similar conditions will be encountered in any substitute well drilled close by. On the other hand, if the farmor's geologic information suggests that hydrocarbons are most likely to be found at the location of the initial well, or if the farmor particularly wants information from that location, the farmor will not want to give the farmee discretion to drill elsewhere.<sup>256</sup>

One way to break an impasse either as to the location of the substitute well or as to whether the farmee is to be obligated to drill it, is to provide the farmee an incentive in the form of a larger percentage, deeper depth, or more acreage in the earning provisions. If the farmee that has tried in vain to drill an initial well in a location tries a second time and succeeds, it may make sense to the parties that the farmee should earn more than it would have had the initial well been successful.

## 15. *The Performance Standard*

### a. *Conduct of Operations*

Since a farmout agreement is a business transaction similar to a construction contract, a "good and workmanlike" standard of performance may be implicit.<sup>257</sup> Many agreements specifically define the standard to which the farmee must work, however, usually by reference to due diligence and good and workmanlike conduct.<sup>258</sup> Obviously the standard set may affect substantially the farmee's potential liabilities and chances of earning.

### b. *The Earning Standard*

The farmee has the burden of proving that it has met the standard set by

256. A formulation that farmees should avoid is what one may call an "illusory" substitute well right, such as would be created by a substitute well provision that called for the farmee to have the right to drill a substitute well "at a location acceptable to farmor." Such a provision may not be enforceable at all. If enforceable, it gives the farmor complete control of the substitute well.

257. *Cf.* True Oil v. Gibson, 392 P.2d 795, 797-800 (Wyo. 1964) (drilling not "commenced" under terms of lease when preliminary activities not performed with good faith intention of completing performance).

258. A typical example of a clause defining the standard of performance in the conduct of operations is:

All test well and substitute well operations *will be conducted with due diligence, in a good and workmanlike manner*, in compliance with all laws, rules, regulations and orders of governmental authorities asserting jurisdiction, with the terms and provisions of the leases affected and with the provisions of all third party agreements relating to such operations, including any agreements with other parties in the chain of leasehold title, and without cost, risk, liability or obligation to farmor, expressly or by implication. Farmee will pay all bills before delinquency and will keep and preserve the lease free of all liens, charges and encumbrances arising out of their acts and operations thereon . . . .

(Emphasis added.)

the farmout to earn its interest.<sup>259</sup> Absolute performance will be the presumed requirement. It has been held that substantial compliance is inappropriate for farmout agreements.<sup>260</sup> Most farmout agreements specifically require absolute performance by the farmee to earn its interest.<sup>261</sup> On occasion, however, the farmor will accept the farmee's substantial performance.<sup>262</sup> A farmee's representative should certainly negotiate the issue.

Farmees should avoid two performance standards occasionally found in farmout agreements. One requires that the farmee perform "to the farmor's satisfaction" in order to earn the interest.<sup>263</sup> Though a standard designated by reference to the discretion of one of the parties will probably be limited by reasonableness,<sup>264</sup> such a standard is an invitation to litigation. A second pernicious performance standard requires that the farmee must request assignment of its earned interest in writing within a specified period and that it forfeits the interest if it fails to do so.<sup>265</sup> Such a provision may well be enforceable on the theory that a court's function is to give effect to the agreement that the parties have made, rather than to write the contract that the parties should have written.<sup>266</sup>

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259. See *Inexco Oil Co. v. Crutcher-Tufts Corp.*, 389 F. Supp. 1032, 1040 (W.D. La. 1975); see also Klein & Burke, *supra* note 3, at 494-95 (discusses *Inexco Oil* and the parties' interest in depth as substance of farmout agreement). But see *Vickers v. Peakers*, 227 Ark. 587, 300 S.W.2d 29, 32 (1957) (court found "unless" assignment pursuant to farmout had not terminated although drilling never reached objective depth).

260. *Inexco Oil Co. v. Crutcher-Tufts Corp.*, 389 F. Supp. 1032, 1040 (W.D. La. 1975).

261. See, e.g., Scott, *supra* note 3, at 84 (requires assignment by farmor only "If Farmee . . . complies fully with all the provisions of this agreement to Farmor's satisfaction.>").

262. For example:

In drilling all wells under this Agreement, Farmee shall conduct all operations connected therewith in accordance with the standards of a reasonably prudent operator. Farmee shall employ such practices as are consistent with sound engineering, effective geological exploration, and oil field safety. Farmee shall substantially comply with all applicable laws and governmental rules and regulations.

\* \* \*

For all wells drilled under this Agreement, Farmee shall substantially perform and comply with all of the material covenants, terms, and provisions contained in Exhibit "B", entitled "Provisions Applicable to Test Wells", attached hereto and made a part hereof by reference.

\* \* \*

Upon substantial compliance with each of the material covenants, terms, and conditions set forth in this Agreement, each Farmor shall upon written demand by Farmee, assign or cause to be assigned to Farmee . . . the following:

(Emphasis added.)

263. See, e.g., *supra* note 261.

264. *Supra* note 207.

265. See Scott, *supra* note 3, at 84. For example: "Farmee shall request any assignment earned hereunder in writing within 30 days from completion of the earning well. If such timely request is not made, all rights and interests which farmee may then have under or by virtue of this agreement shall automatically terminate." *Id.* Several of the agreements collected contained similar language.

266. Cf. *Chevron USA, Inc. v. Belco Petroleum Corp.*, 755 F.2d 1151, 1154-55 (5th Cir. 1985); *Royal Bank of Canada v. Joffre Resources Ltd.*, [1985] 5 W.W.R. 75, 80-81 (Alberta Q.B.).

## B. Well Information

The second major group of important issues addressed in farmout agreements relates to the information that the parties develop in the course of drilling the well. What tests are to be conducted? What information is to be shared by the farmee with the farmor? When and under what conditions is the sharing to take place? These issues fundamentally affect the farmee's cost of performance. They also affect the value of the farmout transaction to both the farmor and the farmee.

### 1. Tests to be Conducted

The parties often list tests that the farmee must perform in the course of drilling in an appendix attached to the farmout agreement. Because of their physical location and because the lawyers who draft or review farmout agreements often do not understand the technical terms that are used to describe the tests, the testing provisions tend to get little attention. That oversight can be very expensive for both the farmor and the farmee.

The tests required under the farmout are important to the farmee because the farmee is obligated to pay the costs of testing. If the farmout requires extensive and expensive testing, the burden of drilling increases greatly. An attorney drafting or reviewing a farmout agreement on behalf of a farmee, therefore, must either understand the necessity for and the probable costs of the tests required or specifically defer to the business judgment of the client on these matters.

A "blank check" requirement that the farmee test "to the farmor's satisfaction" should be avoided. When possible, the contract should set out the specific tests to be conducted. When that is not possible because the parties cannot agree or cannot foresee what will be necessary, reference to the prudent operator standard may be advisable.<sup>267</sup>

The farmor is equally concerned about what tests are to be conducted. Even if the farmor's primary purpose in farming out is to get a well drilled to preserve its lease, the testing information is likely to be important for what it may tell the farmor about other leases that it may own in the area. Where the farmor's goal in farming out is to get leases explored, the information developed from testing may prove more important to the farmor than whether or not the drilled wells produce in paying quantities. One drafting or reviewing a farmout agreement for a farmor, therefore, needs to understand equally as much as any counterpart working for the farmee what the various kinds of tests that the agreement may specifically require and what kind of information they may develop.

Farmout agreements commonly provide that the farmor's representatives

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267. For example: "In the course of drilling the initial well or any substitute well provided for herein, farmee agrees to do such evaluation and to have made such electric, radiation and porosity surveys as a prudent operator would do, or have made, under the same or similar circumstances . . . ." (Emphasis added.) It may also be advisable, at least from the farmee's view, to provide specifically that testing need not be done if there are no commercially viable "shows" of hydrocarbons.

will have "the freedom of the rig floor," which in the trade means that the farmor has the right to all information derived from testing in the course of drilling.<sup>268</sup> In addition, many agreements will specifically require the farmee to provide testing information.<sup>269</sup>

As a practical matter, the importance of testing to both the farmee and the farmor means that the attorneys representing the parties cannot work in a vacuum. They must consult with their clients' scientific personnel. They must ask the hard questions. Is there a clear understanding as to what the terminology used to describe the testing means? What will it cost? Will the information produced be worth the cost? When and under what conditions is information to be supplied?

## 2. *When Must the Farmee Supply Testing Information?*

When the farmee must supply information derived from testing may be crucially important to the farmor. The farmor may have leases in the area that it needs to evaluate before their primary terms expire. The farmee may "steal a march" on the farmor by withholding testing information until the farmee can use it in evaluating its leases or formulating its lease acquisition program for the area. Farmout agreements, therefore, commonly set time limits for the farmee to provide testing information.<sup>270</sup> When the agreement requires absolute performance to earn, the farmee should give careful consideration to these time limits.

268. Cage, *supra* note 3, at 165; Klein & Burke, *supra* note 3, at 502.

269. For example:

*Farmees shall afford the duly authorized representatives of farmor, at their sole risk, access to the Test Well on all operations incident thereto and shall furnish farmor all information pertaining to or obtained from all operations conducted in connection therewith, including daily drilling reports, copies of any sample analyses made, all reports to government agencies, all test results and copies of all logs (including casing logs) and surveys (including velocity surveys) made, together with such other notices and information as are customarily furnished by the operator to a non-operator working interest owner.*

(Emphasis added.)

270. For example:

The party drilling any well provided for in the Agreement to which this exhibit is attached, agrees and binds itself to observe and comply with the provisions hereinafter contained; failure to comply with such provisions shall release Farmor from its obligations and covenants contained in said agreement.

\* \* \*

2. During the drilling of any well:

\* \* \*

c. *As soon as available*, furnish Farmor with records and representative samples of all cores taken; copies of the results of cores.

d. *Furnish Farmor daily progress reports by telephone or telecopy* giving the nature of all work done and depth and formation penetrated beginning with the date actual work is commenced at the location and continuing until drilling, logging, testing, completing and equipping is completed or if a dry hole, the well has been plugged and abandoned.

\* \* \*

f. *Notify Farmor immediately* when a show of oil or gas has been encountered in drilling or coring, and before any formation is tested or electrical surveys are run, *notify Farmor in sufficient time* for farmor to have representatives present.

(Emphasis added.)

### 3. Confidentiality

The parties may also want to bar or limit the dissemination of the information developed in testing by including confidentiality provisions.<sup>271</sup> While damages may be difficult to prove, confidentiality clauses should be enforceable if damages are proved.<sup>272</sup> In addition, their very presence is likely to avoid disputes.

#### C. What Is Earned?

There are four dimensions to what is earned by drilling under a farmout agreement: the surface area earned, the depth limitations, substances covered, and the percentage of interest earned by drilling. In addition, both the farmor and the farmee must concern themselves with the farmor's overriding royalty, the "carried" costs, pooling provisions, conversion rights, the payout definition, and proportionate reduction provisions.

##### 1. Area Earned

In principle, the farmor's and the farmee's interests under a farmout agreement will always conflict with respect to the acreage that is to be earned. In practice, however, the parties negotiate the area to be earned by the farmee so that it bears a fair relationship to the risks that must be taken. As a general rule, the greater the risks that the farmee must take, the greater the area earned by drilling under the farmout agreement.

The most narrow assignment that may be earned under a farmout agreement may be called a "borehole assignment." A borehole assignment conveys to the farmee only the area actually drained by the borehole drilled.<sup>273</sup>

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271. For example, the following confidentiality provision is from an offshore farmout agreement:

A. The seismic data acquired pursuant to this farmout agreement will be the sole property of farmee and its participants, although black line copies of display sections and a map showing the location of shot points used shall be furnished to farmor for its information and use only.

B. Except as provided in subsection A immediately above, the parties hereto agree that all geophysical, geological, engineering, technical, production tests or other data obtained from all wells drilled under this agreement shall be the property of farmor and farmee and shall be maintained as confidential information for a period of five (5) years from the date hereof, or until such information is made public by the Minerals Management Service, unless both parties agree in writing to a lesser period of time. It is understood that the filing of reports by farmee which are required by governmental agencies shall not constitute a breach hereof. It is also agreed and understood that farmee will be permitted to provide each participant named in Section X below, with a copy of the information and data referred to in this paragraph, subject to the confidentiality provisions of this paragraph.

C. It is understood and agreed that in the event that farmee agrees to relinquish all of its rights under this agreement, the provisions of this section shall not apply to farmor and farmor shall be able to use such data in such attempt or attempts to further farmout this lease.

272. Cf. *Gladys Belle Oil Co. v. Turner*, 12 S.W.2d 847, 848-49 (Tex. Civ. App.—Austin 1929, writ ref'd) (covenant to reassign held enforceable); see *infra* text accompanying notes 362-65.

273. An example of a borehole assignment is:

The farmee does not earn the right to participate in infill drilling.<sup>274</sup>

A second form of limited assignment, and one very commonly seen in the industry, is a "drill site assignment." A drill site assignment provides that the farmee earns the rights to a specified amount of acreage that is designated as the drill site. Generally, the drill site includes the acreage dedicated to the drilling or spacing unit that is approved by the state agency with jurisdiction. When there is no state designated drilling or spacing unit, the parties may describe a drill site assignment as a square<sup>275</sup> or a circle<sup>276</sup> around the top of the borehole.

Finally, the farmor may assign the farmee not only the drill site acreage, but acreage outside of the drill site.<sup>277</sup> Assignment of outside acreage is par-

Assignor . . . does, subject to the terms and provisions herein contained, hereby transfer, sell, assign and convey unto the said Assignee, its successors or assigns, without warranty of title, express or implied, all of Assignor's right, title and interest in and to the oil and gas rights only as covered by the oil, gas and mineral lease described in Exhibit "A", attached hereto and by reference made a part hereof . . . *insofar and only insofar as such lease covers rights specifically limited to the well bore of the \_\_\_\_\_ well located in Section \_\_\_\_\_, \_\_\_\_\_ County, \_\_\_\_\_ together with such interest's part of all the production, if any, produced under such oil, gas and mineral lease from such well bore and a like interest in all personal property, fixtures and equipment located on the lands described in Exhibit "A" or used or obtained in connection with such well bore of the \_\_\_\_\_ well.*

(Emphasis added.)

274. An unresolved question is whether the assignee of a borehole assignment under a farmout agreement acquires any right to prevent the farmor from drilling an infill well or to recover damages as a result of the drilling of an infill well that will cause substantial drainage. There may also be question about whether a borehole assignment meets the complete payout test. See *supra* text accompanying notes 22-25.

275. The following describes the assigned tract as a square:

If Farmee [drills] . . . then Farmee shall have acquired all of Farmor's undivided right, title and interests to an undivided \_\_\_\_\_ leasehold interest in and to the Lease and the Lands, insofar and only insofar as the Lease and Lands cover and affect the proration unit established for the Test Well, which proration unit shall be established in accordance with the rules prescribed or permitted by the Railroad Commission of Texas. In the absence of a designation of a proration unit by the Railroad Commission of Texas, then if the Test Well is classified as an oil well, then the acreage assigned thereto shall be 80 acres; if the Test Well is classified as a gas well, the acreage assigned thereto shall be 320 acres. *In either case, the acreage assigned to a well shall be in the shape of a square, as nearly as practicable, with a Test Well in the center thereof.* For the purposes of determining whether the Test Well is an oil well or a gas well, the classification thereof in any form filed in respect thereto with the Railroad Commission of Texas shall be conclusive.

(Emphasis added.)

276. The following describes the tract assigned as a circle:

[After drilling the earning well] you will upon written request to the farmor be provided with an assignment with farmor's interest in its lease(s) or portion of lease(s) under that portion of the Farmout Area included in the unit established for the earning well. Should a unit not be established, said assignment shall cover farmor's interest under that portion of the Farmout Area included in an area having a radius of 300 feet around the earning well.

277. An example of an earning provision that would give the farmee acreage outside of the drill unit, which might be appropriate for use in an exploratory "drill to earn" agreement, follows:

If [the farmee earns] . . . the farmor will assign to farmee:

- (a) an undivided 50 percent of the operating rights and working interests of farmor in the leases subject to this agreement; (b) if, and only if, the test well

ticularly common when the farmout is primarily for exploratory purposes. As discussed above, the practice presents special tax problems.<sup>278</sup>

## 2. Depth Limitations

Just as oil and gas leases may be subdivided into separate surface tracts, they can be subdivided into deep and shallow rights. Farmout agreements often sever leases by placing depth limitations upon what the farmee earns by drilling. Depth limitations may be stated on a footage basis; for example, "6000 feet" or "the total depth drilled."<sup>279</sup> In the alternative, earned rights may be limited by reference to a described formation, generally either the deepest penetrated by drilling operations<sup>280</sup> or the deepest actually producing.<sup>281</sup> The strictest limitation, rarely seen but often discussed, limits the farmee's rights to those formations actually producing. Yet another alternative limits what the farmee earns to the stratigraphic equivalent of the well drilled.<sup>282</sup> Finally, the parties may use some combination of limitations.

All of these limited assignments present potential problems. All are sus-

is completed for production of oil and/or gas, 100 percent of the remaining operating rights and working interests of farmor in the land within the designated drilling and spacing unit established by the \_\_\_\_\_ Commission for the test well, excepting and reserving to farmor [an overriding royalty interest convertible upon payout] . . . .

278. See *supra* text accompanying notes 30-34.

279. An example of a total depth drilled limitation is: "All acreages assigned shall be limited to a depth equal to one hundred feet (100') *below the total depth penetrated* by the test well drilled on the drilling unit acreage." (Emphasis added.) The reason for reference to a specified depth below that actually penetrated is to give the farmee a right to drill deeper, if need be, in order to maintain the production on its well. Sometimes, agreements will grant a specific easement for such purposes:

[The assignment shall] reserve to Farmor all rights below the stratigraphic equivalent of the base of the deepest producing sand as defined in the well completion form filed with the Texas Railroad Commission, except for a vertical easement which shall be assigned to Farmee for operational purposes only in the upper one-hundred feet (100') of those reserved depths.

280. An example of a deepest formation penetrated limitation is:

If Farmee timely commences the drilling of the Initial Test Well, drills it to the contract depth and fully and completely complies with all the other terms, conditions and requirements of this Agreement, upon the completion of the Initial Test Well or Substitute Well as a well capable of producing oil and/or gas in paying quantities, Farmee will have earned an assignment of 100% of Farmor's interest in 160 acres around the drill site tract, being the \_\_\_\_\_ quarter of section \_\_\_\_\_, township \_\_\_\_\_, range \_\_\_\_\_, \_\_\_\_\_ County, \_\_\_\_\_ and limited from the surface to the base of the deepest formation penetrated.

(Emphasis added.)

281. An example of a deepest producing formation limitation, taken from a draft AAPL Form 635 farmout agreement, is "if an assignment is earned, the rights earned will be as follows: "limited to the interval from the surface down to and including, but not below, the base of the deepest producing formation in the earning well." This approach appears more limited than a deepest penetrated formation limitation because it is quite likely that a well drilled will be produced from a shallower depth than the deepest depth penetrated.

282. An example of a stratigraphic equivalent limitation follows:

If the Earning Test Well is drilled and completed as a well capable of producing oil or gas in paying quantities, each Farmor shall assign to Farmee one hundred percent (100%) of the right, title and interest of such Farmor in those portions of the oil and gas leaseholds described in Exhibit "A" (*down to and only down to the stratigraphic equivalent of the total depth drilled in the Earning Test Well*)

ceptible to interpretative disputes similar to those that arise in describing the objective depth.<sup>283</sup> When what is earned is limited to a specified depth expressed in feet, the method used to measure the depth may be ambiguous. The drafter should take care to describe the limitation by reference to vertical depth or measured depth and to define precisely how to measure depth.<sup>284</sup>

If the depth limitation is stated by reference to a formation, the identity and location of the formation may be open to question. In addition, a special problem is likely to be confronted. When the agreement limits the assignment to the base of a specified formation or to some specified number of feet below the base of the formation, the formation must be identified and located, and its base must be clearly discernible. That task may be relatively easy, particularly in areas in which many wells have been drilled or where the lithology at the base of the formation changes abruptly and distinctly. In exploratory areas or in geologically complex areas, however, stating a depth limitation by reference to a formation may be an invitation for geologists to disagree.

A similar problem arises when the description of the assignment refers to the "stratigraphic equivalent" of the depth drilled or of the formation penetrated. The term "stratigraphic equivalent" is used frequently in areas in which noncontiguous parts of the same formation may be found at substantially different depths because of overthrusting or faulting. The general effect of a reference to stratigraphic equivalent is to give the farmee the right to the benefits of its risk-taking by giving it the right to sedimentary strata it drilled, wherever found.

The specific effect of limiting the depth earned to the stratigraphic equivalent may not be clear, however. There are several potential problems. First, the term has a deceptively reassuring sound; it suggests a straightforward scientific test that in fact does not exist in every case. Reasonable geologists may disagree as to whether particular formations or zones are stratigraphic equivalents, and even articulate geologists may have difficulty explaining its application to judges and jurors in terms that they can understand.<sup>285</sup> Second, the term stratigraphic equivalent is potentially ambiguous

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which are included within the spacing unit for the Earning Test Well as established by the applicable state oil and gas regulatory agency or by statute . . . .

(Emphasis added.)

283. See *supra* text accompanying notes 201-05 (discusses objective depth); see also Niblack, *Some Consequences of Horizontal Division of Oil and Gas Leaseholds*, 8 ROCKY MTN. MIN. L. INST. 1 (1963) (discusses how segregation is effected and rights and duties incident to operations of segregated estate).

284. See *supra* text accompanying note 201.

285. As I have worked as a consultant, arbitrator, and expert witness, I have formulated (with tongue only partly in cheek) what I call the "reasonable prudent law professor rule of complexity." I am a reasonable, prudent law professor, of better than average intelligence and education, and if I cannot easily understand a concept or its application, neither will a judge or jury. "Stratigraphic equivalent" fails my test.

This is not to say that "stratigraphic equivalent" should not be used as a limitation. One lawyer who replied to my request for comment said:

Obviously, the term "stratigraphic equivalent" is less definite than a fixed mea-

because it has at least three different meanings. Geologists recognize time-stratigraphic,<sup>286</sup> biostratigraphic,<sup>287</sup> and rock-stratigraphic equivalents.<sup>288</sup> The parties to a farmout generally wish to refer to rock-stratigraphic equivalency, and the way they identify the objective depth may suggest their intention.<sup>289</sup> The parties should specifically define the term "stratigraphic

sured depth, but it is no more indefinite than naming a particular formation (e.g., the 'Upper Morrow Formation') as the objective to be tested by the earning well—which, of course, is a common way to describe how deep the farmer must drill. In either case, geologists could (but usually do not) disagree.

286. Time-stratigraphic equivalents are the sediments deposited and the rocks formed during a specific time; i.e., in a given era, epoch, or age. North American Commission on Stratigraphic Nomenclature, North American Stratigraphic Code, arts. 80, 81, in 67 AM. A. PETR. GEOL. BULL. 841, 869 (1983) [hereinafter Strat. Code]. The Stratigraphic Code uses the term "chronostratigraphic" rather than "time-stratigraphic." Petroleum geologists generally use the latter term, however. For a comprehensive, practical discussion of terminology, see Owen, *Commentary: Usage of Stratigraphic Terminology in Papers, Illustrations, and Talks*, 57 J. SEDIMENTARY PETROLOGY 363 (1987). For example, geologists refer to sands deposited during the Pennsylvania Era, a time interval, as Pennsylvanian sandstones, a time-stratigraphic interval measured by thickness. Strat. Code, *supra*, arts. 66 and 67, at 868. Time-stratigraphic intervals are generally thicker than individual rock-stratigraphic intervals, which form most petroleum reservoirs. Consequently, they are not of immediate importance to petroleum geologists. A time-stratigraphic interval, therefore, will rarely be what the parties intend when they refer to "stratigraphic equivalent" in a farmout agreement; their reference is more likely to be to the potentially petroleum bearing rock layers themselves.

287. Bio-stratigraphic equivalents are rocks that contain similar fossils. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 218 (3d ed. 1981). See also Strat. Code, *supra* note 286, arts. 48 and 49, at 862. "Zones" are examples of bio-stratigraphic units. *Id.* art. 53, at 863. Geologists frequently use zones as references.

288. Rock-stratigraphic equivalents are mappable rock layers with distinctive top and bottom boundaries. Strat. Code, *supra* note 286, arts. 22 and 23, at 855-58. (The Stratigraphic Code uses the term "lithostratigraphic," but geologists generally use the term "rock-stratigraphic.") The "formation" is the primary rock-stratigraphic unit. For example, the "Caseyville formation" is described in H. WILLMAN, E. ATHERTON, T. BUSCHBACH, C. COLLINSON, J. FREY, M. HOPKINS, J. LINEBACK & J. SIMON, HANDBOOK OF ILLINOIS STRATIGRAPHY 163-83 (Illinois Geological Survey Bulletin No. 95, 1975). Formations may contain smaller rock-stratigraphic intervals that are designated as "members." Strat. Code, *supra* note 286, art. 25, at 858. For example, in southern Illinois, the Pennsylvania-age Caseyville formation comprises four separate members. From top to bottom they are the Pounds Sandstone Member, the Drury Shale Member, the Battery Rock Sandstone Member, and the Lusk Shale Member. Stratigraphic sequence, or position, is the primary criterion used to distinguish between the sandstone members and the shale members. The distinctions are difficult to make; they cannot be made with only a short core sample, a hand specimen, or a small outcrop of the formation. Furthermore, none of the sandstone members is comprised only of sandstone or even one type of sandstone. For a discussion of local variability within the Pounds Sandstone and the Battery Rock Sandstone over a distance of eleven miles, see Koeninger & Mansfield, *Earliest Pennsylvanian Depositional Environments in Central Southern Illinois*, in DEPOSITIONAL AND STRUCTURAL HISTORY OF THE PENNSYLVANIAN SYSTEM OF THE ILLINOIS BASIN, PART 2; INVITED PAPERS; NINTH INTERNATIONAL CONGRESS OF CARBONIFEROUS STRATIGRAPHY AND GEOLOGY 76-81 (J. Palmer & R. Dutcher eds. 1979). Alternatively, geologists may describe rock-stratigraphic equivalents by reference to the type of sedimentary rock they constitute; e.g. the Caseyville Sandstone or the Battery Rock Sandstone.

289. The most common way to designate an objective depth in a farmout is by naming an objective rock-stratigraphic unit, whether it is a formally designated formation or member (formally designated rock-stratigraphic units are listed in G. KEROHER, LEXICON OF GEOLOGIC NAMES OF THE UNITED STATES FOR 1936-1960 (United States Geological Survey Bulletin No. 1200 (1966)) or some other informally designated but locally recognized unit, such as the Red Fork Sandstone in Oklahoma. (The Red Fork Sandstone is informally, but effectively described in L. JORDAN, SUBSURFACE STRATIGRAPHIC NAMES OF OKLAHOMA 165 (Oklahoma Geological Survey Guidebook No. 6, 1957)). As indicated above, a formation is a

equivalent," however, as biostratigraphic or rock-stratigraphic and, where possible, refer to well-defined "marker formations."<sup>290</sup> Third, a stratigraphic equivalent may not exist. A limit on depth earned to the "stratigraphic equivalent," therefore, may not be a limit at all.<sup>291</sup> To avoid this possibility, the farmout agreement should state a maximum depth to be earned.<sup>292</sup>

### 3. Substances

An assignment of interest in a lease under a farmout agreement may cover all substances covered by the lease. A farmout that is not specifically limited will have this effect.<sup>293</sup> Sometimes, however, an assignment of interest under a farmout specifically limits the substances covered to oil and gas, or to one or the other.<sup>294</sup> The special circumstances of the parties will determine what substances a farmout covers. For example, the owner of a lease in a known oil producing area may be willing to farm out gas rights, but not oil rights.<sup>295</sup>

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rock-stratigraphic unit. *See supra* note 288. This suggests that the parties intend that "stratigraphic equivalent" in the portion of the agreement limiting what is earned is meant to be "rock-stratigraphic equivalent." If the objective depth is defined as a zone, the inference is that "stratigraphic equivalent" means "bio-stratigraphic equivalent." No inference arises if the objective depth is stated in feet.

290. *See supra* note 289.

291. For example, a formation that has been broken by faulting may also have been pushed laterally a substantial distance so that an offset well drilled may never encounter the "stratigraphic equivalent" of the formation or zone in the earning well in any of the three senses discussed above.

292. For example: "In no event will Farmee earn any rights below a depth of \_\_\_ feet."

293. The rule of construction that a description that is not limited by reference to a fractional interest or to minerals or surface will be construed to be without limitation has been called the "100% rule." *See Ellis, Rethinking the Duhig Doctrine*, 28 ROCKY MTN. MIN. L. INST. 947, 954 (1982).

294. For example, the following assignment is for gas rights alone:

**RIGHTS ASSIGNED:** Subject to the terms and conditions set out herein, Owner hereby grants to Operator the exclusive right and privilege of exploring, testing, and developing the Operating Area *for gas* and, in connection therewith Operator shall be entitled to exercise all the rights and privileges granted the Lessee under the terms of said oil and gas lease *as concerns gas* and all of the gas production from the Operating Area as shall be owned by Operator subject to the following [royalties reserved].

(Emphasis added.) The following language conveys oil rights only:

It is expressly provided that *this farmout agreement only covers "oil and oil rights"* and all rights, titles and interest ancillary or pertinent thereto, including without limitation all right, title and interest of farmor in and to casinghead gas. "Casinghead gas" as used herein is hereby defined as the same defined in the statutes, regulations and judicial decisions of the State of Texas to which reference is here made.

(Emphasis added.)

295. Severing oil rights from gas rights can lead to dispute between the parties as to whether production is "oil" or "gas." A precise chemical or scientific definition is difficult because variations in temperature and pressure both in the reservoir and at the wellhead determine whether hydrocarbons will be produced in liquid or gaseous state. The distinction can have enormous economic consequences, however. An example is the "white oil" dispute in the Texas Panhandle, in which owners of oil rights have argued that overproduction of gas has caused lighter components of oil to vaporize, and owners of gas rights have argued that gas was being produced as oil after artificial cooling. For general discussion, see Cartwright, *Texas*

When the interest earned by the farmee is limited to gas or to oil, the agreement should address the definition of the substances covered. A simple way is by reference to the classification of the farmout well by the conservation authority; e.g., anything produced from a well classified as a gas well is considered to be "gas" for purposes of the farmout.<sup>296</sup> If this approach is chosen, the agreement should also deal with what will happen if the conservation authority changes the classification of the well. An approach that protects the interests of both the farmor and the farmee is to continue the farmee's rights to production from the well drilled, but to modify the acreage earned to conform to the spacing approved for the new classification of the well.<sup>297</sup>

A farmout that covers oil but not gas, or gas but not oil, is an invitation to controversy. Because the meaning of "oil" and "gas" and "oil well" and "gas well" is unclear in many states, a drafter should avoid the distinction unless the business deal requires it.<sup>298</sup>

#### 4. *Percentage Earned*

The percentage earned by the farmee in the leases assigned is also of obvious importance to the parties. The higher the percentage, the better for the farmee. As discussed elsewhere, the working interest earned by the farmee

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*Tea on Ice*, TEX. MONTHLY, Mar. 1985, at 98. Owners of oil rights appear to be winning that particular dispute. See *Hufo Oils v. Railroad Comm'n*, 717 S.W.2d 405 (Tex. App.—Austin 1986, no writ) (white oil was not oil for well classification purposes); *Hufo Oils v. Colorado Interstate Gas Co.*, 802 F.2d 133 (5th Cir. 1986) (white oil production may not be used to classify a well as an oil well under an operating agreement).

296. For example:

the term "gas" as used herein shall mean gas, including all liquid hydrocarbons and other constituent elements produced from a gas well or gas pool, and the classification of a well as a "gas well" or a pool as a "gas pool" by the Oil Conservation Division of the Energy and Minerals Department of the State of New Mexico, or other governmental agency exercising like jurisdiction, shall be conclusive.

297. For example:

It is specifically agreed that if the [name of well] located in [description] is hereafter reclassified by the [conservation agency] as an oil well or if the pool from which said well is producing is hereafter reclassified by the [conservation agency] as an oil pool, then, and in that event, this Contract and Operating Agreement shall be automatically contracted and modified as of the date of such reclassification to cover an Operating Area consisting *only* of the [description] containing 40 acres, more or less, as concerns *oil* rights from the surface to the subsurface depth of 2,900 feet, but in no event below the base of the \_\_\_\_\_ Formation.

The term "oil" as used herein shall mean any petroleum hydrocarbon produced from a well in the liquid phase and which existed in a liquid phase in the reservoir and any gas or vapor or both gas and vapor indigenous to and produced from a pool classified as an oil pool by the [conservation agency].

If this Contract and Operating Agreement is contracted and modified in accordance with this Article X, at every place where the term "gas" or "gas rights" is used in this Contract and Operating Agreement, the term "oil" or "oil rights" shall be substituted therefor on and from the date of such contraction and modification. Except as expressly stated in this Article X, this Contract and Operating Agreement shall remain otherwise unchanged and unamended by the operation of the provisions of this Article X.

298. See *Cage*, *supra* note 3, at 160.

in the well site acreage must at least equal the percentage of the drilling costs paid by the farmee if the farmee is to claim the intangible drilling cost deduction.<sup>299</sup> Only rarely do farmout agreements fail to meet this standard.<sup>300</sup>

The size of the percentage interest earned by the farmee in farmed-out acreage outside of the drill site unit, as well as the interest retained by the farmee after the farmor's "back-in," is subject to negotiation. One generalization that can be made, however, is that the interest earned by the farmee in drilling tends to be greater in times of economic downturn. When marketing conditions make drilling less attractive, the farmor must sweeten the pot to entice the farmee to take the risk. On the other hand, the better the prospect being farmed out, the more attractive drilling becomes to the farmee, even for a smaller percentage of interest. Farmees must evaluate offers with common sense and an eye upon the market in the area.

### 5. *Nonoperating Interest Reserved*

Most farmout agreements provide that the farmor reserves a nonoperating interest in production from the earning well or wells during the payout period. Usually, the interest reserved is in the form of an overriding royalty interest,<sup>301</sup> but other types of nonoperating interests may also be encountered. One author has suggested that the interests of the farmor may be better served in some circumstances by reserving a net profits interest rather than an overriding royalty.<sup>302</sup>

The reason for the retained nonoperating interest is the complete payout tax rule; the farmee must hold a working interest in the earning well until payout in order to obtain the full benefit of intangible drilling cost deduction.<sup>303</sup> The farmor, on the other hand, will want to realize a cash flow from the farmout. Since the tax rules effectively bar the farmor from owning a portion of the working interest until payout, the farmor generally will reserve an overriding royalty interest. Thus, the interests of the farmee in obtaining full tax benefits and the interest of the farmor in obtaining a cash flow are both served when the farmor reserves a nonoperating interest.

The economic impact of the nonoperating interest reserved by the farmor is extremely important to the parties' business deal. In this respect the interests of the farmor and the farmee are in direct contradiction. The farmor will invariably seek a larger retained nonoperating interest rather than a smaller one. In boom times, the farmor commonly retains a 1/8th overriding royalty. The farmee generally seeks to minimize the size of the nonoper-

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299. See *supra* text accompanying notes 17-25.

300. The intangible drilling cost deduction is of great importance to the farmee. Depriving the farmee of this deduction is worth nothing to the farmor, since the farmor cannot claim the deduction unless it pays the costs. See *id.*

301. An overriding royalty is a royalty interest, an interest in production or proceeds free of the costs of production, carved out of the lessee's interest in an oil and gas lease. E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *supra* note 5, at 427-28.

302. L. MOSBURG, *supra* note 3, at 283-84. Net profits interests frequently are reserved in California farmouts. See Himebaugh, *supra* note 3, at 23-24.

303. For a discussion of the complete payout principle, see *supra* text accompanying notes 22-25.

ating interest retained by the farmor. When the industry is in recession, farmees are usually more successful than when the industry enjoys prosperity.

One commentator has suggested compromising the interests of the farmor and the farmee by providing for a sliding scale overriding royalty interest keyed to production.<sup>304</sup> Another has noted that sliding scale overriding royalties do not work well in practice because "part of the incentive to improve production was taken away, there was an open invitation to questionable, if not fraudulent production control methods, and the accounting headaches were multiplied."<sup>305</sup> Today, the more common approach is an overriding royalty that increases after payout.<sup>306</sup>

Drafting for a retained nonoperating interest presents interesting problems. One of the most important is whether the retained interest is to be inclusive or exclusive of existing burdens. A retained interest that is inclusive of existing burdens, typically the landowner's royalty and overriding royalties created for landmen or geologists, places the risk of excess burdens upon the farmor, at least in part.<sup>307</sup> Consider for example, the farmor that reserves an overriding royalty equal to the difference between existing burdens and 25% of total production because it believes that the lease is subject only to a 3/16th landowner's royalty, when in fact the lease is also subject to a 1/16 overriding royalty reserved by the lease broker who originally took the lease. The overlooked "excess" overriding royalty will consume the farmor's retained interest.<sup>308</sup> In contrast, a retained interest that is exclusive of existing burdens places the risk of excess burdens upon the farmee from the start; the interest reserved is in addition to other burdens upon production.<sup>309</sup>

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304. Hemingway, *supra* note 6, at 3, 5.

305. Cage, *supra* note 3, at 164.

306. For example, the following clause would increase the farmor's retained overriding royalty after payout: "At payout (i.e., after such Well has paid to you from the working interest 100 percent of your expenses of drilling, completing, equipping and operating said well) farmor's overriding royalty interest will increase to the difference between 30 percent (30%) and the royalties, overriding royalties, and/or other leasehold burdens."

307. An example of a retained nonparticipating interest that is inclusive of existing burdens is: "The assignment shall reserve to farmor an overriding royalty equal to the difference between existing lease burdens of record as of the date of this agreement and \_\_\_ percent." Another version states:

Until farmee has recovered out of the proceeds from the sale of production from the Initial Test Well or Substitute Well all of the costs and expenses farmee incurs in the drilling, testing, completing, equipping and operating the Initial Test Well or Substitute Well, farmor will retain and reserve 6.25 percent overriding royalty interest, inclusive of all other overriding royalty interest and lease burdens above the normal 12.5 percent land owners royalty interest.

308. Of course, if known and unknown burdens exceed 25%, the excess burden will fall upon the farmee, unless there has been a warranty of title by the farmor.

309. An example of a retained interest exclusive of outstanding burdens is:

Assignor reserves unto itself, its successors and assigns over, above and in addition to all royalties, overriding royalties and other burdens, if any, against the production from said leases, an overriding royalty of \_\_\_ of all of the oil and \_\_\_ of all of the gas, casinghead gas, condensate and other liquid or gaseous hydrocarbons produced and saved from or attributable to said leases during the terms

A second problem relates to the possibility that the farmee will want to drill an additional well on the farmed-out acreage before the earning well has paid out. Will the farmor have the right to participate in the drilling of a second well, or should the farmor be limited to its nonoperating interest? The farmor and the farmee are likely to have conflicting economic interests at stake. If a farmor reserves a nonoperating interest convertible at payout to a working interest, the agreement should address what the rights of the farmor in a subsequent well drilled before payout will be.<sup>310</sup>

Third, is the problem of pooling. The farmout agreement should make it clear that the farmee has the right to pool the farmor's retained interest.<sup>311</sup> Otherwise, a question arises as to whether the farmee may pool and bind the farmor, particularly in Texas.<sup>312</sup>

Finally, the clause providing for the retained nonparticipating interest should specify what costs, if any, the retained interest must bear. Overriding royalty interests are generally free of costs of production, but may be subject

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thereof, including any extension or renewals taken within six months of termination of said leases . . . .

310. An example of a farmout provision reserving to the farmor the maximum flexibility with respect to additional wells drilled before payout is:

*If farmee decides to drill an additional well on any assigned acreage prior to payout of the earning well, farmor shall have the option to either (1) participate in the well or (2) be carried in the well while reserving the overriding royalty and option to convert to a working interest as provided in [reference to reservation provision]. Should farmee choose (1) above, this choice shall be effective with respect to all of the assigned acreage, but farmor shall continue to be carried to payout on any well previously spudded. Should farmor choose (2) above, farmor's election at payout shall be effective with respect to all of the assigned acreage when the first well to payout on the assigned acreage pays out, but farmor shall continue to be carried to payout on any well previously spudded.*

(Emphasis added.)

311. For example:

[Pooling] Assignor grants Assignee, insofar as Assignor has the right to do so and subject always to the terms and conditions of the Leases herein assigned, the right to pool or combine said Leases with other leases or lands so as to establish units containing not more than 640 surface acres (plus 10% tolerance) for the production of gas well gas. In the event any Lease or Leases assigned herein is (are) pooled or unitized with other leases or lands for production of gas as hereinabove provided, the overriding royalty reserved herein shall, as to the lands covered by this Partial Assignment which are so pooled, be paid to Assignor in the proportion that the number of acres assigned herein and so pooled bears to the total number of acres in such pooled unit.

It would be preferable for the clause to provide specifically that pooling by the farmee would bind the farmor's reserved nonparticipating interest.

312. In Texas a pooling or unitization agreement does not bind the owner of a prior outstanding royalty interest. *MCZ Inc. v. Triolo*, 708 S.W.2d 49, 57 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.); *Brown v. Getty Reserve Oil Co.*, 626 S.W.2d 810, 814 (Tex. App.—Amarillo 1982, writ dismissed). *Contra* 2 H. WILLIAMS & C. MEYERS, *supra* note 230, § 221.1(7); Williams, *Stare Decisis and the Pooling of Nonexecutive Interests in Oil and Gas*, 46 TEX. L. REV. 1013, 1015-27 (1968). This doctrine originated in *Brown v. Smith*, 141 Tex. 425, 431-32, 174 S.W.2d 43, 46-47 (1943). The court in *Brown* noted that an overriding royalty owner's interest is real property under Texas law and that a pooling agreement involves a cross-conveyance of the joining parties interests. *Id.* Proceeding from this basis, the court held that absent any showing of intent on the part of the reserved royalty owner, the conferring of a mineral leasehold did not confer the right to dispose of the royalty owner's property. *Id.* at 47. See Jones, *Non-Participating Royalty*, 26 TEX. L. REV. 569, 571, 598-606 (1948) (discusses implications of *Brown* case).

to costs subsequent to production.<sup>313</sup> The law on the issue is not so clear as to make specific drafting unnecessary, however. The meaning of the terms net profit interests, production payments, and carried interests is even less clear. Use of such terms invites litigation unless they are specifically defined.<sup>314</sup>

#### 6. Conversion

The conversion provision of a farmout agreement addresses whether the retained nonoperating interest that the farmor retains to provide a cash flow will be converted at some point in time to a share of the working interest. There are three possibilities: no conversion, mandatory conversion, and optional conversion. Which of these the farmor or the farmee may prefer will depend upon circumstances and the goals of each.

When the agreement lacks any conversion provision, the nonoperating interest retained by the farmor will continue as long as production from the well continues. That may be attractive to a farmor needing additional cash flow or commitment of reserves, or to one distrustful of the business acumen of the farmee, or anticipating marginal production. Omitting a conversion provision may also be attractive to a farmee expecting prolific production. A nonoperating interest (for example, a 1/16th overriding royalty) will be less of an economic burden if production is prolific than if it is marginal. Generally, however, the parties to farmout agreements are actively involved in the oil business and have a predilection in favor of full participation. Relatively few farmouts omit conversion provisions for the nonoperating interest retained by the farmor.<sup>315</sup>

If the nonoperating interest retained is convertible to a working interest, the farmee generally prefers mandatory conversion.<sup>316</sup> Mandatory conver-

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313. See *Cline v. Angle*, 216 Kan. 328, 532 P.2d 1093, 1097 (1975). Often, a farmout clause that reserves an interest in the farmor will specifically state that the interest is free of all production costs. For example: "This overriding royalty shall be free and clear of all costs of production, gathering, completion, dehydration, trucking, transportation, marketing, treating, and taxes except applicable windfall profit, excise, ad valorem, gross production and severance taxes."

314. See *Aminoil USA, Inc. v. OKC Corp.*, 629 F. Supp. 647, 650-54 (E.D. La. 1986). In *Aminoil* the farmor and the farmee disagreed over whether actual or imputed interest and legal expenses were properly chargeable against the net profits account. *Id.* at 648. The jury was permitted to consider expert accounting testimony, since the agreement was not explicit. *Id.* at 650.

315. If the farmor does not have the right to convert its overriding royalty, the agreement may provide to increase it after payout. See *supra* note 306.

316. An example of a mandatory conversion provision follows:

If and only if, the test well is completed for the production of oil and/or gas, farmor shall assign to farmee 100 percent of its operating rights and working interest in the acreage within the designated drilling and spacing unit established by the \_\_\_\_\_ Commission for the test well, excepting and reserving to farmor, in addition to any other overriding royalties or nonoperating burdens on production, an overriding royalty of 1/16th of an 8/8ths of all oil, gas and associated substances produced and saved from the test well until payout of the well, at which time the reserved overriding royalty of farmor shall terminate and 50 percent of the operating rights and working interest of farmor assigned under this subsection will automatically revert to farmor, and the test well, the material and

sion, or no conversion, gives the farmee additional certainty. The farmor, in contrast, generally prefers to maintain flexibility by retaining an option either to retain its overriding royalty or to "back in" to a working interest.<sup>317</sup> The structure adopted usually reflects nothing more than the bargaining leverage of the parties.

The conversion structure adopted may present some special drafting problems. One is whether the farmor that either elects not to convert its nonoperating interest into a working interest or is barred from doing so, has a right to participate in in-fill drilling. This is similar to the problem discussed above of whether the farmor should participate in drilling before payout, and similar drafting devices will deal with this situation.<sup>318</sup> Another problem is the effective date of the conversion, whether mandatory or optional. Farmout agreements often make the conversion effective on the first day of the month following payout.<sup>319</sup> While that approach may be administratively convenient, the delay may cost the farmor a substantial amount. The farmor with an option to convert will prefer to have its election effective immediately.<sup>320</sup>

## 7. Payout

As discussed above, the payout definition in a farmout agreement is of crucial importance if the farmee is to obtain the benefits of the intangible drilling cost deduction.<sup>321</sup> For the farmee to obtain the full benefit of the deduction, it must own a share of the working interest of the well drilled equal to the percentage of the intangible drilling costs claimed until recovery of all of the costs of drilling, completing, equipping, and operating attributable to that interest.<sup>322</sup> Conversion of the farmor's retained interest must not

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equipment therein and thereon, and all production thereafter recovered therefrom and the operating rights and working interest in the farmed out lands in the drilling and spacing unit will be earned thereafter by farmor and farmee in equal 50 percent shares.

(Emphasis added.)

317. An example of a conversion option is:

If the Initial Well or any Subsequent Earning Well reaches the Objective Depth and is completed as a commercial well, and if it has been drilled in accordance with all of the terms and conditions of this agreement, farmee shall have earned, and farmor will deliver upon farmee's written request an assignment of the oil and gas rights as defined in this Article. The assignment shall:

\* \* \*

6. Reserve to farmor the option after payout to convert its overriding royalty to a \_\_\_ percent (\_\_\_\_\_% ) working interest in the assigned acreage and in all leasehold equipment, materials, and production.

See also Scott, *supra* note 3, at 84-85 (¶ 6(d) of example agreement).

318. See *supra* note 310 and accompanying text.

319. For example: "Any such exchange [of an overriding royalty interest for a working interest] shall be effective as of 7:00 a.m. on the first day of the month after the month in which payout occurred." See Cage, *supra* note 3, at 165.

320. See *supra* note 310, in which the quoted optional conversion provision continues: "The party shall promptly execute a recordable instrument setting forth farmor's election, which shall be effective as of 7:00 a.m. on the first day following payout."

321. See *supra* text accompanying notes 17-25.

322. For the language of the revenue rulings' definition of complete payout, see *supra* note 22.

occur before complete payout. Drafters have devised no "magic" language to express the complete payout definition.<sup>323</sup> No tax problem should arise, however, so long as it is apparent that the complete payout test is satisfied.<sup>324</sup>

Whatever the definition of payout adopted, the parties face the practical problem of determining whether payout has occurred. Most farmout agreements provide for periodic reports from the farmee to the farmor.<sup>325</sup> In addition many agreements give the farmor specific audit rights for an agreed time.<sup>326</sup> Still, interpretive disputes frequently arise. In *Humble Exploration Co. v. Amcap Petroleum Associates—1977*<sup>327</sup> the parties disagreed over whether the Windfall Profit Tax should be included with "production, severance or other similar taxes" in calculating payout.<sup>328</sup> The court of appeals held that it should because for the farmee the tax was a liability that reduced the proceeds of production it actually received.<sup>329</sup> In *Continental Oil Co. v. American Quasar Petroleum Co. of New Mexico, Inc.*<sup>330</sup> the issue was whether expenses incurred by a farmee as the result of a blowout were to be taken into account even though they were covered by insurance.<sup>331</sup> The Tenth Circuit held that they were, because the farmout agreement did not require the farmee to obtain insurance, and the farmee could not claim the premiums paid as a cost in computing payout.<sup>332</sup> In *Mengden v. Peninsula Production Co.*<sup>333</sup> the dispute was whether production from pooled units was

323. Some definitions do not even mention the term "payout":

At such time as Farmee has recovered out of its share of production from the Earning Test Well an amount equal to all costs to Farmee for all services and material necessary for developing, equipping, operating, and maintaining the Earning Test Well, including all drilling, testing and completion costs of said Earning Test Well, and for ad valorem, severance, and other taxes upon or measured by production and applicable to Farmee's working interest share of production, each Farmor shall have the separate right to convert its reserved 1/16th of 8/8ths overriding royalty, as proportionately reduced pursuant to the provisions of Section \_\_\_ above, into a like proportion of an undivided fifty percent (50%) share of the working interest in the Earning Test Well site or portion thereof to which its said overriding royalty applied . . . .

324. For an excellent and comprehensive discussion of "Payout" for tax purposes, see P. MAXFIELD & J. HOUGHTON, *supra* note 27, ¶ 9.04[5].

325. See Scott, *supra* note 3, at 85:

Each calendar month following each assignment requested hereunder, and until the final notice of payout, Farmee will furnish Farmor a report showing in reasonable detail the monthly and cumulative status of payout and the supporting data therefor. Promptly after payout occurs, Farmee shall so notify Farmor and advise that the option is exercisable.

\* \* \*

*Id.*

326. The agreement attached at Scott, *supra* note 3, at 85 continues, "For two years following each payout, Farmee shall maintain, and Farmor shall have the right to audit, all records pertaining thereto."

327. 658 S.W.2d 860 (Tex. App.—Dallas 1983, writ ref'd n.r.e.).

328. *Id.* at 862.

329. *Id.* at 863.

330. 599 F.2d 363 (10th Cir. 1979).

331. *Id.* at 364.

332. *Id.* at 365.

333. 544 S.W.2d 643 (Tex. 1976).

to be allocated wholly to payout of the farmout upon which the wells were located or apportioned between the farmouts in proportion to the acreage that each contributed to the units.<sup>334</sup> The Texas Supreme Court held that apportionment was required on the basis of a labored interpretation of the agreement.<sup>335</sup> These cases clearly suggest that payout should be defined as fully as the parties can agree.

Another problem is how to handle money contributions that may be received by the farmee. Most farmouts are silent on this issue. When the farmout does address the issue, generally the parties will agree that the farmor and the farmee will share money contributions proportionately to their ultimate interests in the farmed-out acreage.<sup>336</sup> The farmee would prefer to reserve contributions for itself, and that is sometimes done, particularly in agreements in which the farmor retains only a nonoperating interest without right of conversion.<sup>337</sup> Of course, if the operating agreement is made effective upon the execution of the farmout agreement, the provisions of the operating agreement will govern.<sup>338</sup>

*a. Requiring More Than the Tax Rule*

Often the farmee and the farmor negotiate a variation on the payout con-

334. *Id.* at 644.

335. *Id.* at 648.

336. The most common way of accomplishing this is to credit the amount of cash contributions to payout. For example:

Farmoutor hereby relinquishes to farmoutee all of farmoutor's working interest in said well and the production therefrom until such time, hereafter called the "payout", as the gross revenue from said production (or market value, if taken or sold by farmoutee) equals the cost of drilling, testing, completing, equipping and operating said well, plus the cost of marketing production therefrom, *but less any cash contribution for or on account of the drilling of said well.*

(Emphasis added.) Note, however, that the language does not address acreage contributions.

337. The parties probably assume that the farmee is entitled to keep contributions if the agreement does not address the issue. They should explicitly address this issue, however, to avoid argument as to whether an implied obligation to share contributions exists. *Cf. Smith, Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners*, 32 ROCKY MTN. MIN. L. INST. 12-1 (1986) (discuss implied duties).

338. See art. VIII.C. of the AAPL 1977-610 Model Form Operating Agreement. This model provision provides:

While this agreement is in force, if any party contracts for a contribution of cash toward the drilling of a well or any other operation on the Contract Area, such contribution shall be paid to the party who conducted the drilling or other operation and shall be applied by it against the cost of such drilling or other operation. If the contribution be in the form of acreage, the party to whom the contribution is made shall promptly tender an assignment of the acreage, without warranty of title, to the Drilling Parties in the proportions said Drilling Parties shared the cost of drilling the well. If all parties hereto are Drilling Parties and accept such tender, such acreage shall become a part of the Contract Area and be governed by the provisions of this agreement. If less than all parties hereto are Drilling Parties and accept such tender, such acreage shall not become a part of the Contract Area. Each party shall promptly notify all other parties of all acreage or money contributions it may obtain in support of any well or any other operation on the Contract Area.

*Id.* The AAPL 1982-610 Model Form Operating Agreement contains a similar agreement.

cept. Depending upon the adversaries' respective bargaining powers, they may define payment more liberally or more restrictively.

So long as the complete payout tax rule is satisfied, the farmee is entitled to the full intangible drilling cost deduction. Thus, a farmout agreement drafted so that the event that will permit the farmor to convert its nonoperating interest to a working interest is some multiple of the cost of drilling, completing, equipping, and operating the earning well, will result in no adverse tax effect upon the parties.

One circumstance in which the parties may agree that the payout definition should include expenses not required by the tax rules is when a substitute well has been drilled. So long as the substitute well is not considered to be a continuation of the initial well,<sup>339</sup> tax law does not appear to require that the initial well's costs be considered in computing payout. The farmee will certainly want them to be considered, however. Surprisingly, farmout definitions of payout rarely focus upon this issue. A farmout that contains a substitute well clause should specifically address whether the costs of drilling an unsuccessful initial well are to be taken into account in computing payout of the successful substitute well.

*b. Requiring Less Than the Tax Rule*

If the parties choose a definition of payout not as restrictive as that of the Internal Revenue Service, the farmee may lose a portion of the intangible drilling cost deduction. A classic example, called the "basket payout" problem,<sup>340</sup> arises in the context of the multiple well farmout. In Revenue Ruling 80-109, the IRS denied deduction of 25% of IDCs incurred by a farmee who entered into a farmout agreement to drill wells on two noncontiguous tracts in exchange for 100% of the working interest in each tract until the aggregate income from both tracts equaled payout, after which the farmee was entitled to a 75% working interest in each tract.<sup>341</sup> The IRS reasoned that because it was possible that one of the properties would pay out for the other, the complete payout principle was not satisfied.<sup>342</sup> The basket payout problem can be avoided by drafting the payout provision of the multiple well farmout agreement so that payout is determined on an individual well basis.<sup>343</sup>

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339. One could conceivably view a substitute well as a continuation of initial drilling operations, however, particularly when the farmee is obligated to drill the substitute well. *See, e.g., Holt Oil & Gas Corp. v. Harvey*, 801 F.2d 773, 780-81 (5th Cir. 1986) (sidetracking operation part of drilling of initial well under art. VI.A. of 1977 Model Form Operating Agreement). Article VI.B.4 of the 1982 Model Form Operating Agreement attempts to clarify the ambiguity.

340. The term "basket payout" is used to describe the situation where the revenues from more than one well are used to compute payout. Brand, *Acreage Contribution Trades*, LANDMAN, May 1982, at 16.

341. Rev. Rul. 80-109, 1980-1 C.B. 129.

342. *Id.*

343. The following is a well-by-well payout provision:

For these purposes, "payout" shall be deemed to occur when proceeds or market value of production from *any* well completed on the above described lands, (after deducting production taxes, royalty, overriding royalty and like burdens)

### 8. *Proportionate Reduction*

Farmout agreements generally contain proportionate reduction clauses for the same reason that they are found in oil and gas leases. In leases, the proportionate reduction clause protects the lessee against having to pay more than the percentage of royalty and the amount of other lease payments bargained for.<sup>344</sup> If the lessor owns less than 100% of the mineral interest, the clause will proportionately lessen his royalty. In a farmout agreement, the proportionate reduction clause works to reduce the farmor's retained nonoperating interest and the working interest to which it may be converted if the farmor owns less than the percentage lease interest that it purportedly has farmed out.

Proportionate reduction clauses in leases and farmout agreements also involve much the same interpretative problems. The most common dispute is whether the parties intended that the proportionate reduction clause should apply in a particular situation. A farmout agreement typically deals with three "blocks" of property interests of different sizes and types belonging to the farmor. One block is the interest farmed out to the farmee. The second block is the nonparticipating interest reserved. The third is the interest to which the nonparticipating interest reserved converts after payout. An agreement can define all of these blocks as "net" percentages, without proportionate reduction, or it can state them as "gross" numbers, subject to proportionate reduction. Disputes arise when the parties mix these situations.

Consider a situation in which a farmor signs a farmout agreement purporting to farm out 100% of the working interest, subject to a 6.25% overriding royalty interest convertible to 50% of the working interest after payout, but the farmor only owns a 25% working interest. The stage is set for trouble if proportionate reduction provisions do not specifically apply to all three interests. If the proportionate reduction provision does not apply specifically either to the overriding royalty reserved or to the after-payout conversion right of the farmor, the farmee may find the economics of its deal substantially less attractive than it originally anticipated. If proportionate reduction does not apply to the interest farmed out, and the farmor has warranted title, the farmor may be liable.

The drafting technique is easy to state, but difficult to apply consistently. The technique requires either that the farmout state all three of the farmor's interests, the leases farmed out, the nonoperating interest reserved, and the

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shall equal 100% of Second Party's actual cost of drilling, testing, equipping and completing *the* well, including the actual cost of any reworking, deepening or plugging back, plus 100% of the actual cost of operation of *the* well; the proceeds of production and the cost of such development and operation to be attributable only to the undivided interest subject hereto if less than the full interest in the oil and gas. *Payout shall be determined and the option shall be exercised separately as to the proration unit around each well drilled on the above described land.*

(Emphasis added.)

344. J. LOWE, *supra* note 9, at 251.

after-payout conversion, in gross and then proportionately reduce them, or that all three interests be stated as "net" and none be reduced.<sup>345</sup>

#### D. Administration

Farmout agreements may include a variety of administrative provisions. Administrative provisions are not generally essential to the structure of the contract; the parties could perform under a farmout agreement if they were omitted entirely. Properly drafted administrative provisions make the parties' relationship under the agreement smoother, however, and may be crucial to the business success of the agreement. Administrative provisions may be as important in particular situations as any of the essential issues of farmout agreements.

##### 1. Operating Agreement

Because the farmor and the farmee are likely to end up owning working interests in a producing well or in leases that they may jointly develop, operating agreements accompany most farmout agreements.<sup>346</sup> The parties often attach an operating agreement as an exhibit to a farmout agreement.<sup>347</sup> The parties may also incorporate the operating agreement by reference or refer to it in an agreement to agree.<sup>348</sup>

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345. The most common way of stating proportionate reduction provisions in farmout agreements is to provide that the farmout covers, and the farmee can earn, "all of Farmor's right, title and interests" in operating rights and working interests in specified leases, and then to provide for proportionate reduction of the overriding royalty reserved and the working interest to which it may be converted in separate provisions. "Cleaner" draftsmanship would include a single proportionate reduction provision applicable to all three blocks of property interests.

346. Of course, if the farmor retains only a nonconvertible nonparticipating interest such as an overriding royalty, an operating agreement is not necessary.

347. For example:

Farmor and Farmee agree to execute an Operating Agreement, in the same form as the instrument *attached hereto as Exhibit B*, which shall govern the conduct of operations pertaining to the Earning Well. Except as otherwise expressly provided in this Agreement, the terms and provisions of the Operating Agreement shall apply to and govern the rights and obligations of the parties with respect to all of the land included in the Drilling Unit for such well, the Leases included in such Unit, the Earning Well drilled thereon, the production therefrom, and the rights and obligations of the parties relating thereto, and shall be effective as of the date of commencement of operations for drilling the well with respect to which the Operating Agreement is executed. In the event of a conflict between the terms and provisions of the Operating Agreement and this Agreement, then the terms and provisions of this Agreement shall prevail and control. Any delay in executing the applicable Operating Agreement shall not prevent it from controlling the rights and obligations of the parties, and in such event the parties shall have the same rights and obligations as if the applicable Operating Agreement had been timely executed.

(Emphasis added.)

348. For example:

If Farmor elects to exchange its reserved overriding royalty interest for a leasehold interest as provided for in Paragraph \_\_ above, then from the effective date of such exchange any and all further operations on the lands covered by the assigned lease(s) shall be pursuant to the terms of a *mutually acceptable operating agreement* which shall (a) designate you as operator; (b) use an identical

An issue that the parties must address is when the operating agreement should become effective. The more common approach makes the operating agreement effective at the time that the farmor and the farmee become cotenants of the working interest. That may be after drilling of the earning well when the farmee earns an interest as a cotenant with the farmee in acreage outside the drill site. When the farmee earns no interest in outside acreage, the operating agreement may become effective only when the farmor's retained nonparticipating interest in the well converts to a working interest.<sup>349</sup>

Another approach makes the operating agreement effective from the execution of a farmout, insofar as it does not conflict with the farmout agreement.<sup>350</sup> This approach is appropriate when the farmee pays less than all the costs of drilling in return for a proportionate part of the working interest or when a conditional transfer occurs at the time the farmor and the farmee sign the agreement. Even when the farmor and the farmee are not co-owners, this approach offers the advantage of applying to what is often a very informal agreement the very detailed provisions of the model form operating agreement. The detailed provisions may not fit, however, and the farmor and the farmee may disagree as to whether they apply. Moreover, making the operating agreement effective upon execution of the farmout increases the risk to the farmor of vicarious liability.<sup>351</sup>

## 2. *Handling Lease Payments*

An administrative problem that most farmout agreements address is whether the farmor or the farmee is to make payments that may come due under the farmed-out leases. The most common structure provides that the farmor will make all payments until the earned interest is assigned, subject

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accounting procedure as that attached hereto as Exhibit \_\_\_\_, except that the adjustment of overhead rates provided for in said accounting procedure shall be adjusted from the date of this Agreement and (c) provide for a 300% cost recoupment provision for non-consent operations through the wellhead.

(Emphasis added.)

349. The following is an example of a clause providing that the operating agreement will become effective only when the farmee and the farmor become cotenants:

The Joint Operating Agreement attached hereto as Exhibit "C" and by reference made a part hereof will become applicable to all the Subject Lands to the depth provided in the assignment as provided in this agreement as follows:

A. As to the Earning Test Well Site in which a Farmor may elect to convert its reserved overriding royalty interest to a working interest as provided in § 11.2(b) above, upon the election of such Farmor to so convert.

B. Immediately upon Farmee receiving an assignment of interest as herein provided as to all other of the Subject Lands and Subject Leaseholds.

In the event of a conflict between the provisions of this Farmout Agreement and the Joint Operating Agreement attached hereto as Exhibit "C", the provisions of this Farmout Agreement shall control; provided that the provisions of the Operating Agreement concerning payment of rents, royalties, expenses, construction costs, drilling and exploration costs, judgment claims, liabilities, and liens and defense of lawsuits, and any other costs or liabilities incurred in respect of operations conducted pursuant to such Operating Agreement shall control with respect to such operations.

350. See *supra* note 347.

351. See *infra* text accompanying notes 406-38.

to total or partial reimbursement by the farmee.<sup>352</sup> This structure makes administrative sense even when the farmor assigns the interest upon execution of the agreement rather than after the drilling of the earning well. The risk of losing a lease as a result of making improper payment of delay rentals or shut-in royalties is minimized by having the farmor, which already has the leases "set up" on its administrative records, continue to make payments. Of course, the parties may agree to the contrary, as for example when the farmor is farming out and withdrawing from the active conduct of business.

A related issue is what liability, if any, the farmor has if loss of title results from the farmor's failure to make lease payments properly. Farmout agreements usually disclaim any liability by the party handling the payments for loss of title as a result of a failure to make payments properly.<sup>353</sup> The rationale for limiting liability is that administration is undertaken as an accommodation, rather than for a profit from the administrative activity.

### 3. Compliance with Leases

Farmout agreements typically include general language obligating the farmee to comply with all express or implied covenants of the leases farmed out.<sup>354</sup> The genesis of such language is probably the farmor's concern that courts will classify the transaction as a sublease so that the farmor will remain liable to its lessors for breach.<sup>355</sup> A farmee should be aware that such

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352. For example:

Farmors shall continue to pay delay rentals or shut-in royalties coming due after the date of this Agreement required to maintain in force any of said leases, and until completion of the Initial Earning Well or the earlier termination of Farmee's rights hereunder, Farmee shall within thirty (30) days after receipt of billing by Farmors reimburse them for 50 percent of any delay rentals or shut-in royalties so paid. Farmors shall also make any and all shut-in royalty payments that may become due to perpetuate any of said leases on which the Initial Earning Well is drilled hereunder, and will furnish Farmee within thirty (30) days from the date thereof copies of receipts evidencing timely payment. Farmee will reimburse Farmors for 100 percent of such shut-in royalty payments made with respect to the Initial Earning Well. Delay rentals and shut-in royalties payable with respect to said leases (other than those within the spacing unit containing the Initial Earning Well) following the completion of the Initial Earning Well shall be borne 50 percent by Farmors and 50 percent by Farmee and shall be paid as provided in the Operating Agreement.

353. Scott, *supra* note 3, at 86, ¶ 10. This provides that: "Farmor shall pay any delay rentals, shut-in royalties or minimum royalties which may become due . . . [but] Farmor shall never be liable as a result of any failure to make such payments, or portion thereof, in a proper and timely manner." *Id.*; see also *supra* text accompanying notes 114-17 (discusses case with similar clause).

354. For example:

Assignee hereby assumes and agrees to comply with all obligations and covenants, express or implied, imposed upon the lessee in the herein above identified Leases or contained in any intermediate assignments thereof insofar as concerns the interests and premises included in this Partial Assignment, and agrees to indemnify and save harmless Assignor from any risk, liability or expense of whatsoever kind accruing thereunder from and after the effective date hereof.

355. A farmout may well be classified as a sublease because of the rights that the farmor retains. See Klein & Burke, *supra* note 3, at 486-88. If so, the farmor may remain liable to its original lessor for breach by the farmee on a theory of privity of estate despite the language

language may impose upon it a risk of loss of its rights under the farmout, especially when the agreement requires absolute performance in order to earn.<sup>356</sup>

#### 4. *Abandonment and Takeover*

Most farmout agreements contain provisions requiring the farmee to give notice of its intention to abandon a well that it is drilling or operating, and allowing the farmor to elect to take over operations. The reason for abandonment and takeover provisions is that commencement of drilling operations or production is a substantial potential benefit to the farmor, which the farmor does not want to lose because of premature abandonment by the farmee. Abandonment and takeover provisions give the farmor a second chance to drill or operate the farmed-out property.

The abandonment clause commonly provides that the farmee has the right to abandon, if the farmee gives notice of its intent to abandon.<sup>357</sup> When this approach is taken, the clause usually gives the farmor a specific period of time after receipt of notice within which to express its consent or to elect to take over. Consent is implied after the time has run.

The farmee should note carefully the timing and procedures set forth for notice, because failure to comply will likely result in liability.<sup>358</sup> In addition,

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found in most oil and gas leases relieving the lessee of liability to the lessor after assignment of its interest.

356. See *supra* text accompanying notes 259-62.

357. The following provisions of § 5.1 of the draft AAPL Form 635 farmout agreement are typical:

In the event any farmout well is completed as non-productive of oil or gas, or as one not capable of producing oil and/or gas in paying quantities or ceases production, farmee shall immediately give farmor written notice of the proposed plugging and abandonment. Farmor shall have thirty (30) days after receipt of such written notice within which to elect to take over the well for the purpose of conducting additional operations as it desires; except that if a drilling rig is on location, notice to plug and abandon may be given by telephone and farmor's response shall be limited to forty-eight (48) hours, exclusive of Saturday, Sunday and legal holidays. In the event farmor fails to advise farmee of its respective election within the prescribed period of time, then such well shall be plugged and abandoned by farmee in accordance with the terms hereof. Farmor shall have the right to take over such well using so far as necessary, at farmor's expense, the tools and workmen of farmee. Farmor shall pay reasonable salvage value of material and equipment in and on said well, less the cost of salvaging same and acquire said well for its own use and purposes.

The preceding language might not give the farmor the right to take over a well that the farmee abandoned before completion, for example, a well that the farmee abandoned under the escape provisions of the farmout agreement. The following language would avoid that limitation:

Neither the Earning Test Well nor any Substitute Well shall be abandoned without the prior written consent of farmor first had and obtained or without forty-eight (48) hours prior notice having been given by farmee to farmor. Farmor may elect within said forty-eight hour period to examine and make tests of said Earning Test Well or a Substitute Well at its sole cost and risk. Farmor may within said forty-eight hour period or prior to the conclusion of its tests, whichever occurs later, but in no event later than three days after its receipt of notice from farmee, elect to take over from the farmor, said Earning Test Well or a Substitute Well so examined . . . .

358. Cf. *Gladys Belle Oil Co. v. Turner*, 12 S.W.2d 847, 848-49 (Tex. Civ. App.—Austin 1929, writ ref'd) (oil company held liable for a failure to reassess lease as contract required).

the farmee will prefer that the takeover provisions relieve it of liability for the cost of rig time and plugging. Also, the farmee will want payment for the value of salvageable equipment that it leaves in the hole or on the lease after a takeover by the farmor.<sup>359</sup> The farmor must examine the notice provisions carefully to insure that it has adequate time to make a decision about taking over the well, and that it can man an operation it takes over within the time provided.

### 5. Reassignment Provisions

The obligation of the farmee to reassign the lease rights subject to the farmout agreement goes hand in hand with the right of the farmor to take over drilling operations and the right of the farmee to abandon drilling or operations. If the farmout is of the conditional assignment form, reassignment provisions are necessary to clear title, even if the assignment is structured as a determinable interest that automatically terminates if the farmee does not perform.<sup>360</sup> Reassignment is particularly important if the original assignment was recorded. Even if the farmout is of the agreement to transfer form, release and reassignment of rights that may have been earned are desirable to bar title claims at a later date. The reassignment clause may also become important when the lease farmed out has ceased to produce in paying quantities. If the farmee decides not to work over, recompleat, or redrill, the farmor may wish to get back its operating rights so that it may act, but may not feel safe in asserting the right to operate without formal reassignment.<sup>361</sup>

*Gladys Belle Oil Co. v. Turner*<sup>362</sup> illustrates the role of the reassignment clause. In *Gladys Belle* the court held a company that failed its reassignment obligation liable for damages equal to the value of the leases that should have been reassigned.<sup>363</sup> The farmout agreement provided that "if the [farmee]

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*See infra* text accompanying notes 362-65. Proof of damages would be difficult, since a well that the farmee decides to abandon probably has little demonstrable market value. Arguably, however, a court might measure the damage as the cost of drilling a well to the depth at which the farmee abandoned operations. *See Fite v. Miller*, 196 La. 876, 200 So. 285, 289-90 (1940); *Ardizzone v. Archer*, 72 Okla. 70, 178 P. 263, 265-66 (1919).

359. *Glass*, *supra* note 3, at 16. For appropriate language, *see supra* note 357.

360. The well takeover clause often includes reassignment provisions. For example: "Farmee shall, if requested to do so by Farmor, reassign said lease acreage insofar as it covers the portion being surrendered, expiring or abandoned to Farmor free of any encumbrances suffered by, through or under Farmee." Or the clause may provide:

We shall thereafter [after notice] have the portion for thirty (30) days to require you to make a reassignment of the assigned premises or that portion thereof that you wish to surrender or abandon. Such reassignment shall be free and clear of all lease burdens, overrides and payments out of production in excess of or in addition to those previously existing.

361. Of course, if the farmor and the farmee have operated the producing property as cotenants, the operating agreement reassignment provisions will apply. *See, e.g.*, art. VIII.A. of the 1982 AAPL Model Form Operating Agreement.

362. 12 S.W.2d 847 (Tex. Civ. App.—Austin 1929, writ ref'd); *see also* *McLaughlin v. Ball*, 431 S.W.2d 305, 306-07 (Tex. 1968) (suit by assignor against assignee of oil and gas leases for failure of assignee to give assignor written notice of assignee's election to surrender leases resulting in assignor being denied opportunity to reacquire leases).

363. 12 S.W.2d at 848-49.

should desire . . . to surrender any of said leases or not to prosecute development . . . he will reassign said lease or leases . . . not less than ninety days before [they] will expire . . . ."<sup>364</sup> Both the farmor and the farmee assigned their interests. Ultimately, the farmee's assignee permitted one of the leases to expire, and the farmors' assignees sued. The appellate court sustained damages awarded by the trial court, noting that though the parties to the suit were not in privity of contract, the rights and obligations created by the contract were independently assignable.<sup>365</sup> The reassignment clause is not mere space filler.

Generally, reassignment provisions require that the farmee represent that the leases reassigned are free of liens or warrant clear title except as to clouds that existed before the farmee took the property.<sup>366</sup> This approach is consistent with the obligations typically imposed upon a farmee to "conduct operations at no cost to the farmor" and to indemnify the farmor against loss. Some farmout agreements have no reassignment provisions, however, relying upon the abandonment and takeover provisions alone. Specific reassignment provisions can be classified into at least three different general forms: (a) perpetual assignment with reassignment obligation, (b) automatic reversion, or (c) reversion by declaration. Each may present problems.

#### *a. Perpetual Assignment with Reassignment Obligation*

The most common reassignment form is a contractual obligation to reassign, like that in *Gladys Belle Oil Co. v. Turner*.<sup>367</sup> The advantage of such a formulation, particularly when it is coupled with an assignment placed of record, is that it imposes upon the farmee the duty to plug an abandoned well and restore the premises.<sup>368</sup> The disadvantage of a contractual obligation to reassign is that the farmor may have difficulty compelling the farmee to reassign, particularly if the farmee has subleased or assigned interests to others.

#### *b. Automatic Reversion*

A second common formulation is to draft the reassignment provision so that the farmed-out interests revert automatically to the farmor if the farmee abandons or ceases production.<sup>369</sup> One problem with this approach is that

364. *Id.* at 847.

365. *Id.* at 849.

366. *See supra* note 360.

367. *See supra* text accompanying note 362. For the language of an example clause, *see supra* note 360.

368. Of course, the agreement of the farmor and the farmee as to responsibility for plugging or restoration will not preclude the state from asserting its police powers to the contrary. *See infra* text accompanying notes 436-38.

369. For example:

[The assignment shall] [b]e effective as of the date of well completion and *provide for reversion to Farmor of all rights assigned upon the earlier of* (a) thirty (30) days after cessation of all production from or allocated to the assigned premises unless production is restored or operations for restoration of production are commenced within the thirty (30) days and production is restored within a reasonable time after commencement of such operations, (b) forty-five

terms like "abandonment" and "cessation of production" may not have clear meanings, and litigation may result. Furthermore, the right of reversion may expose the farmor to liability for plugging or restoration just as surely as owning a contractual right to reassignment.<sup>370</sup>

*c. Reversion upon Declaration*

A theoretical drafting alternative is to provide that after no production for some specific time, or after production has fallen to some agreed level for a specific time, the farmor can cause the farmed-out interest to revert to the farmor by filing a declaration of reversion. Language similar to that found in lease pooling clauses might be used.<sup>371</sup>

*6. Area of Mutual Interest Provisions*

Because the farmor and the farmee become "economic partners" under a farmout agreement, farmouts sometimes include "area of mutual interest" provisions, usually referred to as "AMI provisions." An AMI provision gives the farmor and the farmee the right to share in interests acquired by the other in a designated contract area, which may be the same as or larger than the farmout contract area, upon agreed terms.<sup>372</sup> AMI clauses are par-

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(45) days prior to any lease termination, or (c) the shut-in of the last producing well on the assigned acreage for more than one (1) year. Farmee shall evidence the reversion by a reassignment to Farmor, free and clear of all liens, claims or encumbrances, except those existing at the date of this agreement; provided, however, the reversion shall be effective whether or not Farmee reassigns to Farmor.

(Emphasis added.)

370. See *infra* text accompanying notes 434-38.

371. There are practical difficulties, however, with providing for reversion of the farmee's interest upon the filing of a declaration by the farmor. First, since the procedure is not specifically authorized by statute, it may merely cloud title. Second, recording officers may refuse to accept such declarations or refuse to index them where they will appear in the chain of title. Perhaps the most workable method of obtaining reassignment at the will of the farmor is to have the reassignment executed and delivered to the farmor at the time of the initial assignment, subject to the understanding that it will be recorded only upon default. It is likely that few farmees will agree to this, however.

372. An example of an area of mutual interest clause follows:

Article X. (a) If either farmor or farmee acquire, during the period from execution of this agreement to the expiration of one year from the completion of the last earning well (i.e., either the initial earning well or a subsequent earning well) under this agreement, any oil and/or gas interest or right to acquire such interest in lands within the Area of Mutual Interest depicted on Exhibit "A" hereto and within a spacing unit containing a well drilled or proposed to be drilled under this agreement and containing a portion of Said Leases, the acquiring party shall offer the non-acquiring party, in the manner provided for in Article XV.F. of the operating agreement, an undivided 50 percent so acquired to the extent contained within such spacing unit. All operations on any such interest in which the non-acquiring party elects to participate shall be governed by Exhibit "C" hereto and the operating agreement.

(b) If during the period described in Article X.(a) above either farmors or farmee acquire any oil and/or gas interest or right to acquire such interest in lands within the boundaries of the area of mutual interest and outside all spacing units containing wells drilled or proposed to be drilled under this agreement, then (i) if the interest is acquired by purchase, the acquiring party shall offer the non-acquiring party an undivided 50 percent of the interest so acquired and

ticularly common in exploratory farmouts.

Area of mutual interest provisions are not peculiar to farmout agreements, and have been the subject of analysis elsewhere.<sup>373</sup> Two particularly important problems should be noted in this discussion of farmout agreements, however. One is whether an AMI provision that is not limited in time violates the rule against perpetuities. A Kansas case holds that an area of mutual interest agreement is purely contractual, that it is not subject to the rule against perpetuities because it creates no rights in real property.<sup>374</sup> An AMI clause in a farmout may also be held to be within an exception to the rule for options to extend leases, if it is viewed as impliedly limited to the duration of the leases.<sup>375</sup> However, it has been argued that a perpetual AMI might well violate the rule, so that the AMI provision should be specifically limited in time.<sup>376</sup>

A second and more practical concern to one drafting or analyzing an AMI clause in a farmout agreement is what land or leases are to be subject to the AMI provision. The parties should specifically define the geographical area to which the AMI applies. In addition, the clause should address what kinds of interests are subject to the mutual interest provisions. Are surface interests, mineral interests, and royalty interests to be covered as well as leasehold interests? What about property acquired that may be partly within and partly outside of the contract area? Finally, the provision should address whether, if the farmor or the farmee acquires several properties at once, the election to acquire will apply to the package as a whole or permit

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(ii) if the interest is acquired by farming or other agreement requiring the drilling of a well or performance of other act besides the payment of money in order to earn or acquire the interest, the acquiring party shall offer the non-acquiring party an undivided percentage interest in the acquisition sufficient to vest 25 percent thereof in farmors and 75 percent thereof in farmee. Such offer shall be made and accepted in the manner provided in Article XV.F. of the operating agreement. All operations on any such interest in which the non-acquiring party elects to participate shall be governed by Exhibit "C" hereto [drilling, geological, and engineering requirements] and the operating agreement.

In the absence of a specific AMI provision, the courts will not likely give either the farmee or the farmor the right to share in interests or leases acquired on adjacent acreage. See *Opco v. Scott*, 321 F.2d 471, 472-73 (10th Cir. 1963). But see *Smith, Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners*, 32 ROCKY MTN. MIN. L. INST. 12-1, 12-49 to -57 (1986).

373. See *Zarlengo, Area of Mutual Interest Clauses Regarding Oil and Gas Properties: Analysis, Drafting, and Procedure*, 28 ROCKY MTN. MIN. L. INST. 837, 837-83 (1982) (checklist for analysis and drafting).

374. *First Nat'l Bank & Trust Co. v. Sidwell Corp.*, 234 Kan. 867, 678 P.2d 118, 127 (1984) (quoting *Courseview, Inc. v. Phillips Petroleum Corp.*, 258 S.W.2d 391, 393 (Tex. Civ. App.—Galveston 1953, writ ref'd n.r.e.), *rev'd and remanded on other grounds*, 298 S.W.2d 890 (Tex. Civ. App.—Galveston 1957), *modified*, 158 Tex. 397, 312 S.W.2d 197 (1958)).

375. See *Zarlengo, supra* note 373, at 850, discussing the exception of the RESTATEMENT OF PROPERTY § 395 (1944).

376. *Id.* *Zarlengo, supra* note 373, at 849-50. For specific language that limits the AMI agreement to one year after completion of the last earning well, see *supra* note 373. If the farmout agreement specifies a completion date for the earning well, such language almost certainly will comply with the rule against perpetuities. If there is no specific completion date, however, a well commenced possibly could not be completed within the perpetuities period. An interesting subissue of AMI clauses, if the clause violates the rule against perpetuities, is whether the clause is void or whether the whole farmout agreement is void.

the nonacquiring party to pick and choose among the properties.<sup>377</sup>

### 7. *Restrictions upon Assignment*

Farmout agreements often include restrictions upon assignment. From the farmor's view, a restriction may be a practical necessity. The farmor, having located a farmee that it considers skilled, trustworthy, and solvent, wants to be certain that the rights given by the farmout are not transferred to a farmee that possesses none of those attributes. If the farmor wishes to restrict assignment of rights under the farmout, it must do so specifically and unambiguously.<sup>378</sup> Courts will strictly interpret restrictions,<sup>379</sup> and will not imply them from the terms of a reassignment clause in the farmout.<sup>380</sup>

The farmor may pay a price for restricting assignment, however. Usually the farmor's goal is to get a well drilled on the farmed-out acreage. To the extent that the restriction against assignment makes it difficult for a farmee to raise money by assigning interests, it may be counter-productive.<sup>381</sup> Thus, the parties may choose to make the rights of the farmee freely assigna-

377. Zarlengo, *supra* note 373, at 872-76.

378. Probably the most common formulation is a flat proscription. For example: "This Agreement shall not be assigned in whole or in part by Farmee without the prior written consent of Farmor." Some proscriptions of assignment are more specific, probably in an attempt to avoid an implied limitation of "reasonableness":

No provision of this agreement or of any assignment [lease] made or issued hereunder shall be modified, altered or waived except by the express written agreement of Farmor. This agreement is personal to Farmee, and Farmee shall have neither the right nor the power to assign this agreement, in whole or in part, to another party without the express prior written consent of Farmor thereto. Likewise, Farmee shall have neither the right nor the power to assign any interest, in whole or in part, under any assignment [lease] made or issued pursuant hereto without the express prior written consent of Farmor thereto. Farmor may withhold its consent to any such proposed or attempted assignment for any reason or no reason in the sole discretion of Farmor. Any attempted assignment made in contravention of this provision shall be, at Farmor's sole option (and in addition to any other remedy available to Farmor at law or in equity), voidable and of no force and effect. The granting of consent by Farmor to any such assignment shall be effective only as to the specific assignment then the express subject of such consent, and all subsequent assignments which may be proposed or attempted shall likewise be expressly subject to the hereinabove stated and reserved rights, power and authority of Farmor.

Some parties have couched proscriptions in affirmative language, though their effect is still to limit: "This AGREEMENT shall inure to the benefit of and be binding upon the Parties hereto and their successors and assigns; provided, however, Farmee shall make no assignment of its rights hereunder without Farmor's prior written consent."

379. *Gladys Belle Oil Co. v. Turner*, 12 S.W.2d 847, 848-49 (Tex. Civ. App.—Austin 1929, writ ref'd). A reassignment clause in a farmout provides that the farmee will reassign to the farmor any leases transferred under the agreement that it decides to surrender or not to develop. *See supra* text accompanying notes 360-71.

380. *See Rainbow Oil Co. v. Christmann*, 656 P.2d 538, 546-47 (Wyo. 1982). In *Rainbow Oil Co.* the court held that a right of first refusal included in a farmout agreement obligating the farmees to offer to sell the interest earned back to the farmor if the farmees "shall elect to sell their interest" was not triggered by a company officer's transfer of interests to his company in satisfaction of his fiduciary obligations or by a gift to one of the farmees' children. *Id.* at 543-44. In *Palmer v. Liles*, 677 S.W.2d 661 (Tex. App.—Houston [1st Dist.] 1984, writ ref'd n.r.e.), the court held that a restriction on assignment without written consent did not create a right of first refusal, but merely gave rise to a claim for actual damages suffered. *Id.* at 663.

381. Glass, *supra* note 3, at 15.

ble,<sup>382</sup> to permit assignment to identified parties,<sup>383</sup> to permit assignment when the proposed assignee is financially strong,<sup>384</sup> to permit assignment when it is likely to be conducive to getting the property drilled,<sup>385</sup> or to limit the restriction in time.<sup>386</sup>

In addition, the farmor faces a risk that courts will regard a broadly

382. A clause that permits assignment, but specifically keeps the original farmee obligated to the farmor is:

The rights hereunder may be assigned in whole or in part by Farmee, but, prior to the date when an assignment or lease is earned hereunder, if Farmee assigns an interest in the Farmout Interests pursuant to this letter agreement, *Farmee shall remain liable to Farmor and Farmor shall have the right to look solely to Farmee in connection with any cause of action it may have with respect to this agreement*, to the same extent as if such assignment had not been made by Farmee.

(Emphasis added.)

383. The following is an example of a clause that permits assignment to identified parties:

This Agreement shall not be assigned in whole or in part . . . . However, Farmor specifically agrees to allow Farmee to make an assignment to its participants in the \_\_\_\_\_ Exploration Program, namely, \_\_\_\_\_. These participants currently share in all costs and liabilities of the Program with Farmee. Also, Farmor agrees to allow \_\_\_\_\_ to make an assignment to an affiliate.

When such language is used, the agreement should define "affiliate."

384. The following language addresses financial suitability as a basis for permitting assignment:

Farmee shall not assign, transfer or otherwise dispose of any rights hereunder without first obtaining written consent from Farmor; provided however that Farmor shall neither unreasonably deny or delay its assent to such request if Farmee satisfies Farmor that its proposed assignee exercises at least the same degree of financial responsibility as Farmee. This agreement shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, successors and assigns.

385. For example:

The following assignments, conveyances and successions of a Farmee's rights and interests under this Agreement may be effected without the prior written consent of Farmor, to-wit:

- (i) a conveyance by reason of the death or legal incapacity of a party comprising Farmee;
- (ii) a conveyance to a spouse or issue of a party comprising Farmee;
- (iii) a conveyance to a trust for the benefit of a spouse or issue of a party comprising Farmee;
- (iv) a transfer to another party comprising Farmee;
- (v) a transfer to a joint venture or partnership (general or limited) of which a party comprising Farmee is a member and has the sole authority, irrevocably during the term of such entity, to act for such entity with respect to the properties that are the subject matter of this Agreement.

All other assignments, conveyances and successions of a Farmee's rights and interests under this Agreement shall be effected only with the prior written consent of Farmor, which consent will not be withheld unreasonably.

386. A restriction limited in time follows:

Assignee agrees not to assign, either in whole or in part, its interest in said land, or in the oil or gas to be produced therefrom, without the written consent of Assignor, *the restriction to be effective for fifteen (15) years from the date hereof*. Any assignment shall contain a limitation requiring that the written consent of Assignor must be obtained prior to any further assignment. No such assignment or assignments, although made with the written consent of Assignor, shall subject said land or any portion thereof, to any overriding royalty, payments out of production, net profit obligation, carried interest or any other obligation in addition to those created under the terms hereof.

(Emphasis added.)

drafted restriction upon assignment as an unenforceable disabling restraint against alienation.<sup>387</sup> Most lawyers look to landlord and tenant law as they draft restrictions on assignments in farmout agreements, reasoning that the farmor's interest in restricting earning rights under the farmout and operating rights after the farmed-out acreage has been earned is as important as the identity of the tenant to a landlord.<sup>388</sup> The analogy overlooks the fact that the nature of an oil and gas lease differs from a real property lease. The former is either a fee simple determinable estate in land or a determinable profit à prendre or license, rather than a mere term of years. Courts are more likely to tolerate restrictions upon alienation that will eventually terminate than those that may be perpetual.<sup>389</sup> Though no court appears to have thoroughly discussed the issue, a Canadian commentator has argued that broad restrictions on assignment in farmout agreements should not be enforceable.<sup>390</sup>

A step short of declaring restrictions upon assignment to be invalid disabling restraints is to reason that they are not covenants running with the land, but mere personal service covenants. When this characterization is adopted, restrictions upon assignability are valid only as to executory contracts, because after performance "the contract is no longer one for personal services and the reason for non-assignability no longer exists."<sup>391</sup> Following this reasoning, the Tenth Circuit upheld an order requiring specific performance of a promise to convey acreage under a farmout in *Socony Mobil Oil Co. v. Continental Oil Co.*<sup>392</sup> when the farmee's assignment to which the farmor objected took place after the earning well had been drilled.<sup>393</sup>

Something less than a complete proscription can, in most cases, meet the farmor's interest in restricting assignability. The parties can restrict assignment until the farmee performs the farmout contract, but permit it thereafter, since the interests of the farmor are most acute while drilling is

387. A disabling restraint is one that expressly denies the grantee the power to transfer the estate or declares any attempt to transfer automatically void. Except when used in spendthrift trusts, disabling restraints are always held void. R. BERNHARDT, *REAL PROPERTY IN A NUTSHELL* 77 (West 1982).

388. RESTATEMENT OF PROPERTY § 410 (1936) provides that:

A promissory restraint or forfeiture restraint on alienation of a legal possessory estate for years is valid if, and only if

- (a) the estate for years is created as the result of a business transaction, the requirements of the rule against perpetuities are satisfied and the restraint is
  - (i) imposed at the time the estate for years is created, or
  - (ii) agreed to thereafter as a business transaction by the persons who are in the relationship of landlord and tenant . . . .

389. RESTATEMENT (SECOND) OF PROPERTY §§ 406, 407, 410 (1973). A limitation upon the restriction similar to that *supra* in note 386, therefore, is doubly attractive.

390. Nowack, *Restrictions Against Alienation in Agreements Relating to Oil and Gas Interests*, 23 ALBERTA L. REV. 62, 73-74 (1985); see also Scott, *Restrictions on Alienation Applied to Oil and Gas Transactions*, 31 ROCKY MTN. MIN. L. INST. 15-1 (1985) (discusses restrictions on assignment in agreements).

391. *Prudential Fed. Sav. & Loan Ass'n v. Hartford Accident & Ins. Co.*, 7 Utah 2d 366, 325 P.2d 899, 904 (1958).

392. 335 F.2d 438 (10th Cir. 1964).

393. *Id.* at 442.

progressing.<sup>394</sup> When the farmor's likely reasons for objecting to an assignment can be identified, the farmout agreement can specifically spell out those reasons, and limit assignment in those circumstances.<sup>395</sup> Assignment may also be barred subject to the farmor's consent, "which consent shall not be unreasonably withheld."<sup>396</sup> "Reasonableness" limitations should prevent classification of a restriction upon assignment as a disabling restraint.<sup>397</sup> Finally, the agreement may permit the farmee to make partial assignments so long as it remains the operator and legally responsible to the farmor.<sup>398</sup>

#### 8. *Calls on Production, Options to Purchase, and Prior Commitments*

Some integrated oil companies with refining capacity routinely include in their farmout agreements calls on production, options to purchase, or prior commitments. A farmor whose purpose in farming out is to obtain reserves or to acquire access to market may also include these devices. A call on production gives the holder a right to require another to sell its share of production to a purchaser designated by the farmor.<sup>399</sup> An option to

394. For example:

It is agreed that the Farmee's rights and interests under this contract shall not be assigned prior to the time that the Farmee has earned the interest provided for in this agreement by drilling a conforming well; provided, however, that after the Farmee has earned an assignment of interest under this agreement, the Farmor agrees that Farmee may assign the interest so earned in whole or in part.

395. For example, the following:

Farmee shall not assign any interest in this Assignment until it has given Farmor notice of the complete details of the proposed transaction and Farmee has received Farmor's written consent to assign. Farmor will not unreasonably withhold its consent to assign, but consent may be withheld when Farmor, in its sole discretion but in good faith, believes such assignment may diminish the value of Farmor's rights, reservations, and exceptions under this Assignment.

Of course, the more specific the standard the better.

396. For example:

Farmee, for itself, its successors and assigns, covenants and agrees that prior to the drilling and completion of the Earning Test Well and Farmee's compliance with the performance of all of the terms and provisions of this agreement, it will not transfer or assign this agreement without the prior written consent of Farmor, which consent shall not be unreasonably withheld.

Often, the parties will couple a "reasonableness" limitation with more specific limitations. For example language, see *supra* note 385.

397. See RESTATEMENT (SECOND) OF PROPERTY § 406 comment i (1973). This section includes a list of factors that tend to support a conclusion that a restraint is either reasonable or unreasonable. *Id.* Section 407 of the Restatement makes these factors applicable to defeasible possessory estates in fee. *Id.* § 407.

398. Glass, *supra* note 3, at 15; see *supra* note 382.

399. A very broad call might read as follows:

**6.1 Oil Production.** Farmor shall have a continuing option to purchase Farmee's share of oil and liquid hydrocarbons produced and saved from the Farmout Lands through standard lease separator facilities, to the extent such production is attributable to the interest assigned to Farmee hereunder. The option may be exercised by Farmor at any time and from time to time while such production continues, by giving written notice thereof to Farmee not less than 30 days before the date on which farmor's purchases are to commence. The price paid by Farmor for such production shall be equal to the prevailing wellhead market price then being paid in the same field for production of the same or similar grade and gravity, or if there is no such prevailing price being

purchase is more limited. It gives the holder a right to purchase another's production, but only if the other elects to sell.<sup>400</sup> A prior commitment binds both the farmor and the farmee to a sales contract.<sup>401</sup>

Calls on production and options to purchase present drafting problems. The duration of the call or the option, how and when it may be exercised, and how to determine the price to be paid for production are issues that the parties must address as specifically as possible to avoid the objection that the call or option is an unenforceable agreement to agree. Prior commitments present similar problems when the contract terms are to be determined later.

All of these devices may present unsettled legal issues. Whether calls on

paid in the same field, the prevailing price being paid in the nearest field. Farmor may terminate its purchases by giving written notice thereof to Farmee not less than 30 days before the date of termination.

*6.2 Gas Production.* Farmor shall have the option to purchase Farmee's share of gas, including casinghead gas, produced and saved from the Farmout Lands through standard lease separator facilities, to the extent such production is attributable to the interest assigned to Farmee hereunder. When Farmee's gas becomes available for purchase initially and at any time thereafter, Farmee shall so advise Farmor in writing and Farmor shall have 60 days thereafter to give Farmee written notice of Farmor's election to purchase the gas at the prevailing wellhead market price paid for gas at the same or similar quantity and quality in the same field (or if there is no such price then prevailing in the same field, then in the nearest field in which there is such a prevailing price) pursuant to comparable purchase contracts entered into on the same or nearest preceding date as the date of Farmor's election to purchase gas hereunder.

T. FAY, *supra* note 3, at 57.

400. An option to purchase might read as follows:

Assignor reserves and is hereby given the optional preferential right at any time and from time to time to enter into a contract to purchase or designate a purchaser for all of Assignee's gas produced from said land, such right to be exercised as follows. If Assignee elects to sell gas production and shall receive a bona fide offer acceptable to it to purchase such gas production, it shall promptly furnish Assignor written notice thereof and Assignor shall have ninety (90) days after receipt of such notice to elect either to enter into a contract to purchase such gas on the same terms and conditions of such offer, or to designate a third party purchaser of such gas on either the same terms and conditions or (in its sole judgment) on more favorable terms and conditions to Assignee, and if any such third party purchaser is designated, such designation shall be binding on Assignee. If Assignor fails to notify Assignee within said ninety (90) day period of its election to exercise such right, then it shall have no right to exercise said preferential right during the contract term. If Assignor does not exercise such optional preferential right and for any reason Assignee shall not thereafter accept said offer, or if Assignee accepts said offer and the resulting contract expires or is terminated or renegotiated, then the foregoing reservation of said optional preferential right shall continue in full force and effect and said optional preferential right shall apply with respect to any new offer or renegotiated offer to purchase gas from said land.

401. An example of a prior commitment clause for gas follows:

All interests in natural gas and casinghead gas presently owned by farmee within the area of interest, and all interests in natural gas and casinghead gas hereafter owned, or, controlled by farmee within the area of interest will be subject to a gas purchase contract with farmor as buyer and farmee as seller, a copy of which is attached hereto as Exhibit \_\_\_\_\_. Said gas purchase contract is being executed contemporaneously with the execution of this agreement.

Sometimes the commitment will be to enter into a contract at a later date on terms prevailing in the market at that time. In such cases, a prior commitment may contain price terms much like those of the call seen *supra* note 399.

production or options to purchase create interests subject to the rule against perpetuities is uncertain. To avoid the issue, some drafters limit calls and options to the perpetuities period<sup>402</sup> and require that the contract to which production is committed be executed with the farmout.<sup>403</sup> Another area of concern is that calls, options, or prior commitments may violate federal or state antitrust laws. Whether antitrust is a real problem will depend upon the characteristics of the companies involved, the amount of land subject to the call, option, or prior commitment, and the competition in the area.

A third unsettled issue is whether a call, option, or prior commitment may subject the farmor and the farmee to corporate taxation, which would sharply limit the value of the intangible drilling cost deduction and the percentage depletion allowance to both parties, as well as subject them to double taxation of distributions. A farmout transaction creates an association taxable as a corporation if it possesses sufficient corporate characteristics.<sup>404</sup> To avoid corporate taxation, the parties to oil and gas transactions ordinarily structure the arrangement so that each has the right to take production in kind or separately dispose of it. One of the essential characteristics of an association taxable as a corporation is a joint profit objective.<sup>405</sup> If the parties have the right to take in kind, they have no joint profit objective; they have separate individual profit objectives. When production is subject to a call, an option to purchase, or a prior commitment, the farmout agreement does not meet the literal requirements of an association taxable as a corporation.

Perhaps the reason that calls on production, options to purchase, and prior commitments do not appear more frequently in farmout agreements, however, is the chilling impact that they have upon the business deal of the parties. In the usual situation, neither the farmor nor the farmee wants to tie up its share of production from the farmed-out property. Each prefers to reserve the flexibility to sell production at a later time.

## 9. Liability, Insurance, and Indemnity

The risks inherent in oil and gas drilling are enormous. People may be

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402. For example:

We shall have and shall reserve the optimal right for a period of twenty-one (21) years from the date hereof, to purchase all oil produced and saved from the lands and leases committed hereto at the prevailing market price; said price is meant to be that price being paid in the immediate field for oil of like kind, quality and gravity, in like quantities and under contracts providing for similar conditions and durations, such price to be determined from month to month.

Some courts might imply a "reasonable" limitation upon the duration of the call. *Rex Oil Co. v. Busk*, 56 N.W.2d 221 (Mich. 1953).

403. See *supra* note 401.

404. Treas. Reg. § 301.7701-2(a)(1) as amended in 1983 lists six corporate characteristics: associates, a joint profit objective, continuity of life, centralization of management, limited liability, and free transferability. For minerals transactions, whether title is in the name of one of the parties may be a seventh factor.

405. I.T. 3930, 1948-2 C.B. 126 and I.T. 3948, 1949-1 C.B. 161 reason that if the parties have the right to take in kind, there is no joint profit objective. For a discussion of this subject, see Houghton, Braden & Harris, *supra* note 59, at 6-8 to -10.

injured, massive pollution may occur, and great cost overruns are routine. Therefore, both the farmor and the farmee should be concerned about their potential liability, and the insurance and indemnity provisions of the farmout agreement.

a. *Liability*

The farmor and the farmee may assume that each will be liable only for its own contracts and torts since the relationship of the parties is no closer than that of cotenants. Nevertheless, the relationship established under a farmout agreement may provide grounds for vicarious liability. These include (i) joint ventures and mining partnerships, and (ii) liability as a record title owner.

i. *Joint Ventures and Mining Partnerships*

A joint venture is "a special combination of two or more persons, where, in some specific adventure, a profit is jointly sought, without any actual partnership or corporate designation."<sup>406</sup> It is a partnership for a single transaction. A mining partnership is an association of two or more persons to jointly conduct a business and to share in the expenses, profits, and losses of the enterprise.<sup>407</sup> It is a cross between a tenancy in common and a true partnership.<sup>408</sup>

The joint venture and mining partnership concepts may be viewed as separate<sup>409</sup> or as indistinguishable.<sup>410</sup> Either theory or both may be used to impose liability upon the farmor or the farmee for damages or expenses incurred in drilling under a farmout agreement.<sup>411</sup> The classic case in the area is *Shell Oil Co. v. Prestidge*.<sup>412</sup> In *Prestidge* the court held Shell liable as a joint adventurer for injuries suffered by Prestidge while Shell's farmee drilled at a site in Idaho.<sup>413</sup> The court held that the farmout agreement and

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406. *Griffin v. Reilly*, 275 S.W. 242, 246 (Tex. Civ. App.—Amarillo 1925, no writ).

407. *Ellis v. Lewis*, 119 Okla. 201, 202, 249 P. 295, 296 (1926).

408. *Gilbert v. Fontaine*, 22 F.2d 657, 660 (8th Cir. 1927).

409. The primary distinction between a joint venture and mining partnership is that the former has the characteristic of *delectus personae*; that is, the death or bankruptcy of one of the partners terminates a joint venture, and a joint venturer has the right to exercise choice in admitting new members to the enterprise. In contrast, a mining partnership does not automatically terminate upon death or bankruptcy; the purpose of the relationship is mining, and since that purpose would be thwarted and the property damaged by debate over new partners, the mining partnership interest is freely transferable. *Munsey v. Mills & Garitty*, 115 Tex. 469, 480-89, 283 S.W. 754, 758-62 (1926).

410. In *Smith v. Rumpy*, 198 S.W.2d 592, 594-98 (Tex. Civ. App.—Amarillo 1946, no writ), the court used the terms interchangeably.

411. *Brimmer, Mining Partnerships*, 15 ROCKY MTN. MIN. L. INST. 85, 95 (1969). See generally *Boigan & Murphy, Liabilities of Non Operating Mineral Interest Owners*, 51 U. COLO. L. REV. 153, 164-82 (1980) (discusses contract and tort liability of mining partnerships and joint ventures); *Fiske, Mining Partnership*, 26 INST. ON OIL & GAS L. & TAX'N 187 (1975) (discusses generally mining partnerships and joint ventures); *Jones, Mining Partnerships in Texas*, 12 TEX. L. REV. 410, 414-31 (1933) (discusses elements of mining partnerships in Texas).

412. 249 F.2d 413 (9th Cir. 1957).

413. *Id.* at 416.

the actions of Shell's employee satisfied the elements of a joint venture: a contract between the parties, substantial contributions to the enterprise, and joint control.<sup>414</sup>

A recent unreported case from Oklahoma that imposed liability upon a nonoperator under an operating agreement on the basis of a mining partnership illustrates how that theory may be used against the parties to a farmout. In *Dresser Industries, Inc. v. Crystal Exploration & Production Co.*<sup>415</sup> the Tenth Circuit Court of Appeals found both the operator and Crystal, a nonoperating working interest owner, liable to pay for services and material provided by Dresser.<sup>416</sup> The court held that a mining partnership requires a joint interest in the property, an express or implied agreement to share in the profits and losses of the venture, and cooperation in the project.<sup>417</sup> The court's analysis focused on whether sufficient cooperation existed to impose liability.<sup>418</sup> The court held that management or conduct of operations by the nonoperator was not necessary.<sup>419</sup> It was sufficient that Crystal:

kept in close contact with Schick [the operator], receiving almost daily reports; Crystal asked for and received completion procedures prior to their implementation in order to allow its engineers time to discuss the procedures with Schick; Crystal made recommendations regarding procedures with Schick and Schick accepted them; employees of Crystal visited the location and discussed procedures with Schick and engineering consultants hired to drill and complete the well.<sup>420</sup>

These comments could refer to a farmor's activities under many farmout agreements.<sup>421</sup>

A realistic assessment of the risk of liability as a mining partner or joint venturer in a farmout agreement is difficult because precisely what will trigger liability is uncertain. In *Blocker Exploration Co. v. Frontier Exploration, Inc.*<sup>422</sup> the Colorado Supreme Court held that a cotenant of an oil and gas lease is not liable as a mining partner unless the cotenant takes an active role in the conduct of operations or the agreement gives the cotenant a right to participate in management or control.<sup>423</sup> The court stated that "co-owner-

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414. *Id.*

415. No. 84-1160 (10th Cir. July 12, 1985).

416. *Id.* slip. op. at 6-7.

417. *Id.* at 4.

418. *Id.* at 4-6.

419. *Id.* at 5.

420. *Id.* at 5-6.

421. Of course, the facts will vary from situation to situation:

If the farmoutor simply waits to be advised of completion of the earning work, and upon verification makes the necessary assignment, in the absence of any other involvement, it probably is not a mining partnership. But if the farmoutor, with or without specific provisions in the agreement, injects himself into the drilling effort by offering or providing assistance, or exercising influence or discretion, then he may be committing himself to mining partnership status with the farmoutee.

Fiske, *supra* note 411, at 207-08.

422. 740 P.2d 983 (Colo. 1987).

423. *Id.* at 987.

ship alone does not give rise to a mining partnership."<sup>424</sup> Both Texas and Oklahoma courts have made similar comments.<sup>425</sup> The Colorado court noted that:

[A] non-operating working-interest member "should not be considered, without more, a mining partner if his only rights are to take in kind, receive reports, inspect books, make an election of whether to join in a particular phase of exploration/development (commonly known as a 'go-no-go' decision), or has the right of approval of specified expenditures."<sup>426</sup>

Quoting the court of appeals, the Colorado Supreme Court held that "the determining factor is related to the degree of *active participation in control or management* of the venture that is exercised by a co-tenant or co-owner."<sup>427</sup>

As a practical matter, the ease with which liability as a mining partner or joint venturer is triggered may differ from state to state. Oklahoma and Arkansas apparently require less than Colorado and Texas. Oklahoma apparently requires only (1) a joint interest in the property, (2) an agreement to share in profits and losses, and (3) cooperation in the project to establish a mining partnership.<sup>428</sup> Arkansas may impose liability upon virtually any cooperative drilling arrangement on a joint venture theory.<sup>429</sup> Colorado and Texas, however, have not embraced the joint venture theory. In Colorado and Texas a plaintiff who seeks to establish a mining partnership must prove the right or exercise of "control" over the development of the property, rather than mere cooperation.<sup>430</sup>

424. *Id.* at 985.

425. *See, e.g.,* Luling Oil & Gas Co. v. Humble Oil & Ref. Co., 144 Tex. 475, 486-87, 191 S.W.2d 716, 722 (1945); Templeton v. Wolverton, 142 Tex. 422, 428, 179 S.W.2d 252, 255 (1944); Rucks v. Burch, 138 Tex. 79, 82-83, 156 S.W.2d 975, 976 (1941); Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 76-77 (Tex. Civ. App.—San Antonio 1966), *rev'd*, 429 S.W.2d 866 (Tex. 1968); Nolen v. Rig-Time, Inc., 392 S.W.2d 754, 756 (Tex. Civ. App.—Corpus Christi 1965, writ ref'd n.r.e.); *see also* McAnally v. Cochran, 170 Okla. 368, 46 P.2d 955, 957 (1935).

426. 740 P.2d at 988 (quoting the Colorado Court of Appeals in *Blocker*, 709 P.2d 39, 42-43).

427. *Id.* at 985 (emphasis in original) (quoting 709 P.2d at 42).

428. The *Dresser* case, *supra* note 415, is an example of the liberal Oklahoma view of what it takes to constitute a mining partnership. *See also* Oklahoma Co. v. O'Neil, 440 P.2d 978, 984-85 (Okla. 1968) (evidence supported finding that mining partnership or joint venture in development and operation of oil and gas leases existed between plaintiff and defendants).

429. *See* Texas Oil & Gas Corp. v. Hawkins Oil & Gas, Inc., 282 Ark. 268, 668 S.W.2d 16, 17 (1984). In *Hawkins* the Arkansas Supreme Court held that the 1977 model form operating agreement established a joint venture between the operator and the nonoperator. *Id.* at 17. Although the issue before the Arkansas Supreme Court was whether the operator owed a duty to the nonoperator, the court's reasoning in finding a duty would also result in the imposition of liability upon the nonoperator.

430. *See* Blocker Exploration Co. v. Frontier Exploration, Inc., 740 P.2d 983, 987 (Colo. 1987). *Frontier* is an example of the relatively strict view of what it takes to impose liability as a mining partnership. *See also* Hamilton v. Texas Oil & Gas Corp., 648 S.W.2d 316, 320-21 (Tex. App.—El Paso 1982, no writ) (when operator of oil and gas well had full control of all operations, operator and nonoperator working interest owner were not a joint venture); Duniagan Tool & Supply Co. v. Carroll, 60 S.W.2d 296, 298 (Tex. Civ. App.—Austin 1933, writ ref'd) (to establish mining partnership, joint ownership of mining property, joint operation, shares of profits, community of interest, and mutual agency necessary). For an excellent discussion of the cases from the various states, see Boigan, *Liabilities and Relationship of Co-*

Because what will result in liability as a joint venturer or mining partner is uncertain, the parties should take great care in drafting the farmout agreement. The parties should, and routinely do, disclaim status as partners or co-adventurers,<sup>431</sup> though such "bootstrapping" language is not determinative.<sup>432</sup> In evaluating any farmout proposal, a reviewer must take into account a substantial and ever-present risk of liability. The possibility that insurance or indemnification can protect against such liability is discussed below.<sup>433</sup>

### ii. *Liability by Status as Record Title Owner*

A court may impose liability on the basis of a party's status as an owner of property. In *Houser v. Brown*<sup>434</sup> an appellate court held that one who acquired an oil and gas lease upon which there were unplugged oil wells was liable to plug those wells, despite the fact that he did not know they existed when he purchased the lease.<sup>435</sup> While the problem is not the fault of the lessee, he has a connection with the property that justifies application of the state's police power. This reasoning could result in liability being imposed upon either party to a farmout for the default of the other. The Texas court of appeals in Austin applied similar reasoning in *Railroad Commission v. Olin Corp.*<sup>436</sup> when it found a nonconsenting nonoperator under an operating agreement liable for plugging after the operator defaulted.<sup>437</sup> The court held that the nonoperator's reversionary rights was sufficient to support the liability.<sup>438</sup> The inference is clear that the appeals court would find a farmor liable for a farmee's default in plugging.

The rationale of these cases may be extended to mechanics liens, surface restoration, and other potential liabilities. Again, though drafters should attempt to avoid liability by including boilerplate language in the farmout

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*Owners Under Agreements for Joint Development of Oil and Gas Properties*, 37 OIL & GAS INST. 8-1, 8-39 to -48 (1986).

431. For example:

The liabilities of the Farmor and the Farmee hereunder shall be several and not joint or collective, and nothing in this Agreement or in any instrument executed or delivered pursuant hereto shall be deemed to create a partnership, association, joint venture or agency relationship between the parties or to create any fiduciary obligation between them. No party hereto shall have the authority to bind any other party hereto for any obligation or otherwise to act as agent for another party for any purpose whatsoever, it being understood that all operations conducted by farmee as operator hereunder and under the Operating Agreement are conducted as an independent contractor not subject to the control or direction of Farmee as to the means or manner of performance.

Such disclaimers may also buttress the position of the farmor and the farmee that they are not an association taxable as a corporation. *See supra* note 404.

432. *Gragg v. James*, 452 P.2d 579, 587 (Okla. 1969).

433. *See infra* text accompanying notes 439-45.

434. 29 Ohio App. 3d 358, 505 N.E.2d 1021 (Ct. App. 1986).

435. 505 N.E.2d at 1024.

436. 690 S.W.2d 628 (Tex. App.—Austin 1985, writ ref'd n.r.e.).

437. *Id.* at 631.

438. *Id.*; *see Conine, Rights and Liabilities of Carried Interest and Nonconsent Parties in Oil and Gas Operations*, 37 INST. ON OIL & GAS L. & TAX'N 3-1 (1986).

agreement, it is unlikely to be effective. Insurance, indemnity, and the financial stability of one's economic partner are better protections.

*b. Insurance*

Even without a recognized theory of liability, both the farmor and the farmee are likely to find themselves in court if someone is hurt in drilling or operating. Many farmout agreements therefore specifically provide that the farmee must carry substantial insurance for liabilities such as workers' compensation, employers' liability, contractual liability, public liability, and automobile liability.<sup>439</sup> A surprising number of the farmout agreements reviewed, however, contained no insurance provisions. When the farmout agreement does not impose an obligation upon the farmee to provide insurance, the operating agreement may.<sup>440</sup> Article VII.G. of the 1982 Model Form Operating Agreement requires the operator to provide insurance for the joint account of the parties.<sup>441</sup> Two problems exist with the provision,

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439. For example: "Farmee shall during its operations hereunder, maintain workmen's compensation insurance and general liability insurance with bodily injury limits of \$300,000 per occurrence and property damage insurance with a limit of \$100,000." A more comprehensive example follows:

During the term of this agreement, farmee shall provide the following minimum insurance coverage:

- (1) Worker's Compensation Insurance in accordance with the laws of the State of Texas;
- (2) Employer's Liability Insurance, with limits of not less than \$500,000 per accident;
- (3) Comprehensive General Liability Insurance including contractual liability coverage insuring the indemnity agreement in this agreement with limits of not less than \$500,000 for bodily injury, sickness or death in any one occurrence and \$500,00 for loss of or damage to property in any one occurrence; and
- (4) Comprehensive Automobile Liability Insurance covering all vehicles used by farmee, with minimum limits of \$500,000 applicable to bodily injury, sickness or death in any one occurrence and \$500,000 for loss of or damage to property in any occurrence.

For liabilities assumed hereunder by farmee its insurance shall be endorsed to provide that the underwriters waive subrogation against farmor and its agents and employees. Prior to the commencement of drilling operations, farmee shall furnish farmor with evidence of the required coverage. Any assignee of farmee shall comply with these requirements. Such evidence shall be furnished to farmor at [insert address] and shall identify the Contract Acreage.

440. See *supra* text accompanying notes 346-51.

441. Art. VII.G. of the 1982 A.A.P.L.-610 Model Form Operating Agreement (Kraftbilt, Tulsa) provides:

At all times while operations are conducted hereunder, Operator shall comply with the workmen's compensation law of the state where the operations are being conducted; provided, however, that Operator may be a self-insurer for liability under said compensation laws in which event the only charge that shall be made to the joint account shall be as provided in Exhibit "C." Operator shall also carry or provide insurance for the benefit of the joint account of the parties as outlined in Exhibit "D", attached to and made a part hereof. Operator shall require all contractors engaged in work on or for the Contract Area to comply with the workmen's compensation law of the state where the operations are being conducted and to maintain such other insurance as Operator may require.

In the event automobile public liability insurance is specified in said Exhibit "D", or subsequently receives the approval of the parties, no direct charge shall

however. First, article VII.G. refers to an exhibit, which may not include all the desired coverages or amounts of coverages.<sup>442</sup> Second, the operating agreement may not take effect at least until the farmee has earned its interest and perhaps until payout triggers the farmor's conversion right.<sup>443</sup> If the farmor relies upon the operating agreement to provide for insurance coverage, care must be taken that the operating agreement will be effective during all operations under the farmout.<sup>444</sup> The preferable approach is for the farmout to contain its own insurance provisions.<sup>445</sup>

Unfortunately, providing for insurance coverage in the farmout is not a cure-all either. First, the farmor must ensure that the farmee actually obtains and maintains the required coverage. The farmor can do this in a variety of ways, including itself holding the policy and paying the premiums. Second, an insurance policy is no better than the coverage provided, and many policies specifically exclude or limit coverage for risks such as environmental pollution and blowout. Finally, the obligation to defend imposed by an insurance policy extends only to those designated as insured parties.<sup>446</sup>

### c. Indemnification Provisions

Because of the risk of liability inherent in drilling arrangements and the uncertain protection of insurance, most farmout agreements contain provisions requiring the farmee to indemnify the farmor against liability.<sup>447</sup> Less often, the agreement will include an agreement of the farmor to indemnify the farmee. Of course, any indemnification is no better than the resources of the party offering it.

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be made by Operator for premiums paid for such insurance for Operator's automotive equipment.

442. *Id.*

443. See *supra* text accompanying note 349.

444. Arguably, the insurance provisions of article VII.G. of the 1982 AAPL Model Form Operating Agreement are inconsistent with a typical agreement to transfer farmout, because the interests of the parties under the farmout are dissimilar from those of the operator and nonoperators under the operating agreement.

445. See, e.g., the second example *supra* note 439.

446. See *Texaco, Inc. v. Hartford Accident & Indem.*, 453 F. Supp. 1109, 1112 (E.D. Okla. 1978). In *Texaco* Judge Joseph B. Morris ruled that an insurance company was not required to defend a claim against Texaco as a result of an explosion at a gas station because the policy in question covered the gasoline transporter and did not name Texaco. *Id.* at 1112. The court rejected the contention that the transporter was the agent of Texaco on the grounds that Texaco and the transporter had stipulated to the contrary. *Id.* at 1113. While the court specifically reserved the issues of liability and indemnity under the insurance policy, the case stands as a warning to farmors, and all nonoperators, because farmout agreements, and operating agreements, usually disclaim an agency relationship. One can deal with the problem, of course, by obtaining an endorsement to the policy. For a hair-raising discussion of the limits of liability insurance, see Boigan, *supra* note 430.

447. For example:

Maintenance by farmee of said insurance is in no manner to be considered a limitation of the indemnities set out herein. To the extent allowed by law, farmee shall indemnify and hold farmor harmless from and against any and all claims for damages for every kind to persons or property arising out of or in connection with farmee's operations on the lease, including claims based on acts of farmee's contractors, successors, and assigns, except as to any liability arising out of operations and/or actions of the farmor . . . .

There is good reason for cross-indemnification. The greater risk is that the farmor will be targeted in a suit brought as a result of the farmee's actions, since the farmee controls the drilling operations. The farmor will generally have representatives at the well site, however, and their negligence may expose the farmee to liability.

A point to examine closely is whether the indemnification provision purports to indemnify the parties from their own negligence. The farmor may insert a provision totally shifting risk even for its own negligence.<sup>448</sup> More likely, the parties will agree to a "knock-for-knock" provision making each responsible for its own employees, contractors, or subcontractors regardless of negligence.<sup>449</sup> Or, the farmor may convince the farmee that it should

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448. For language that specifically excludes the operations or actions of the farmor from the indemnity, *see supra* note 447. The following provision, taken from a drilling contract, is not so limited. In fact, it specifically provides that the contractor will indemnify the company against claims of "the Company's employees" . . . and damages to "property of the Company" including those "arising out of the sole or concurrent negligence of the Company":

Contractor agrees to protect, defend, indemnify and hold the Company, its employees, directors, officers, free and harmless from and against any and all losses, claims, liens, demands and causes of action of every kind and character and costs thereof including without limitation judgments, penalties, interest, court costs and any legal fees incurred by the Company in defense of same (including attorneys fees incurred in enforcing this indemnity), arising in favor of any party, including, without limitation governmental agencies, Contractor's employees, the Company's employees, or any third party, on account of claims, liens, demands, debts, personal injuries, death, damage to property including property of the Company, and all other claims of any character, which arise out of, result from or are in any way connected with Contractor's work or its acts, . . . including losses, claims, liens, demands and causes of action of every kind and character arising out of the sole or concurrent negligence of the Company to the full extent such indemnification is permitted by the applicable law. Contractor further agrees to investigate, handle, respond to, provide defense for and defend any claims or suits at its sole expense and agrees to bear all costs and expenses related thereto . . . .

449. An example of a knock-for-knock indemnity provision, taken from the American Petroleum Institute's Model Form Drilling Contract 4C1 (1st ed. Feb. 1983) follows:

11.3 Contractor agrees to protect, defend, indemnify, and save Operator, its joint owners' and their respective officers, directors, and employees harmless from and against all claims, demands, and causes of action of every kind and character, without limit and without regard to the cause or causes thereof or the negligence of any party or parties, arising in connection herewith in favor of Contractor's employees or Contractor's subcontractors or their employees, on account of bodily injury, death, or damage to property. If it is judicially determined that the monetary limits of insurance required hereunder or of the indemnities voluntarily and mutually assumed under Subparagraph 11.3 (which Contractor and Operator hereby agree will be supported either by available liability insurance, under which the insurer has no right of subrogation against the indemnitees, or voluntarily self-insured in part or whole) exceed the maximum limits permitted under applicable law, it is agreed that said insurance requirements or indemnities shall automatically be amended to conform to the maximum monetary limits permitted under such law.

11.4 Operator agrees to protect, defend, indemnify, and save Contractor and its officers, directors, employees and joint owners harmless from and against all claims, demands, and causes of action of every kind and character, without limit and without regard to the cause or causes thereof or the negligence of any party or parties arising in connection herewith in favor of Operator's employees or Operator's contractors or their employees, other than those parties identified in Subparagraph 11.3, on account of bodily injury, death, or damage to property.

accept a modified knock-for-knock provision making the farmee responsible for the negligence of the farmer's contractors and subcontractors as well as its own, on the theory that the farmee is in control of wellsite operations and therefore responsible for safety.

Those drafting or analyzing indemnification provisions should be aware that state statutes may limit their effect. Several states, including Texas, have enacted anti-indemnity statutes that void agreements to the extent that they indemnify a party for its negligence or that of its employees, contractors, or agents.<sup>450</sup> The policy of such legislation apparently is to redress the inequality of bargaining power that may force a contractor to accept onerous indemnification terms.

Anti-indemnification statutes generally merely void offending provisions. Providing for prohibited indemnification carries no penalty other than limiting the offending provision.<sup>451</sup> Furthermore, some anti-indemnification statutes, like the Texas statute,<sup>452</sup> have an exception that permits indemnifi-

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If it is judicially determined that the monetary limits of insurance required hereunder or of the indemnities voluntarily and mutually assumed under Subparagraph 11.4 (which Contractor and Operator hereby agree will be supported either by available liability insurance, under which the insurer has no right of subrogation against the indemnitees, or voluntarily self-insured in part or whole) exceed the maximum limits permitted under applicable law, it is agreed that said insurance requirements or indemnities shall automatically be amended to conform to the maximum monetary limits permitted under such law.

450. A discussion of the Texas and Louisiana laws is found at Tade, *The Texas and Louisiana Anti-Indemnity Statutes as Applied to Oil and Gas Industry Offshore Contracts*, 24 HOUS. L. REV. 665 (1987). The statutes include CAL. CIV. CODE § 2782 (West Supp. 1987); LA. REV. STAT. ANN. § 9:2780 (West Supp. 1987); MICH. COMP. LAWS ANN. § 691.991 (West 1987); MISS. CODE ANN. § 31-5-41 (1986); N.M. STAT. ANN. § 56-7-2 (1978); N.Y. GEN. OBLIG. LAW § 5-324 (McKinney 1987); TEX. CIV. PRAC. & REM. CODE ANN. §§ 127.001-.008 (Vernon 1986); WYO. STAT. § 30-1-131 (Supp. 1980). Section 127.003 of the Texas statute provides in part that:

(a) Except as otherwise provided by this chapter, a covenant, promise, agreement, or understanding contained in, collateral to, or affecting an agreement pertaining to a well for oil, gas, or water, or to a mine for a mineral is void and unenforceable if it purports to indemnify a person against loss or liability for damage that:

(1) is caused by or results from the sole or concurrent negligence of the indemnitee, his agent or employee, or an individual contractor responsible to the indemnitee . . . .

451. TEX. CIV. PRAC. & REM. CODE ANN. § 127.003 (Vernon 1986). This provision is contrary to the general rule in Texas, as well as in most other states. Generally, indemnification against one's own negligence is not contrary to public policy so long as the agreement of the parties is clear. See *Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705 (Tex. 1987). In *Ethyl Corp.* the Texas Supreme Court adopted the "express negligence doctrine," which requires the intent of the parties to indemnify the indemnitee from the consequences of its own negligence to be "specifically stated within the four corners of the contract" in order to be effective. *Id.* at 708. But see *Meloy v. Conoco, Inc.*, 784 F.2d 1320, 1322 (effect of Louisiana anti-indemnity statute limited to nullifying indemnity for indemnitee's own negligence or fault), *vacated*, 792 F.2d 56, *certified to La. S. Ct.*, 794 F.2d 992 (5th Cir. 1986).

452. TEX. CIV. PRAC. & REM. CODE ANN. § 127.005(a) (Vernon 1986) provides that the anti-indemnity provisions do not apply "to any agreement that provides for indemnity with respect to claims for personal injury or death to the indemnitor's employees or agents or the employees or agents of the indemnitor's subcontractors" if the indemnity is supported by insurance. The section provides, however, that "[t]he amount of insurance required may not exceed 12 times the state's basic limits for personal injury, as approved by the State Board of Insurance in accordance with Article 5.15, Insurance Code." *Id.* § 127.005(c). On this basis,

cation for one's own negligence to the extent that insurance supports the indemnity. Thus, broad indemnity provisions should continue to be a priority for each party.

### 10. *Regulatory Provisions*

Some farmouts, particularly those drafted in recent years, include lengthy provisions addressing regulatory matters such as compliance with environmental law, Equal Employment Opportunity Commission regulations, conservation regulations, or securities laws. These provisions, typically regarded as boilerplate by the parties, become important in assigning responsibility or liability.

#### *a. Environmental Regulations*

One of the most common regulatory provisions in farmout agreements provides that the farmee agrees to comply with all applicable environmental regulations. Such a regulatory clause may be short<sup>453</sup> or long.<sup>454</sup> An environmental compliance clause serves two major purposes. First, it should put the farmee on notice of environmental regulations of concern. Of course, the farmor should disclose any specific concerns. Likewise, counsel for a farmee who encounters an environmental compliance clause should inquire specifically whether the farmor is aware of particular potential problems. A sec-

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the maximum enforceable indemnity under § 127.005, as of the time this Article is written, was \$300,000.

453. A short version of an environmental compliance clause follows:

You recognize that one of the primary concerns of the oil industry is compliance with anti-pollution provisions of the environmental regulations. One of the principal considerations of this contract, without which it would not have been made by Farmor, is your agreement, evidenced by your execution hereof, to comply with all Federal, State, and local laws and regulations concerned with prevention and/or control of pollution. You now and hereafter shall hold Farmor harmless from any claims, actions or causes instituted and/or damages or penalties incurred for your failure to timely comply therewith.

454. An example of a more elaborate environmental compliance clause follows:

Operator agrees to comply with the Clean Air Act (42 U.S.C. § 1857) and the Federal Water Pollution Control Act (33 U.S.C. § 1251) when conducting operations involving nonexempt contracts. In all nonexempt contracts with subcontractors, Operator shall require:

- (1) No facility to be utilized by Subcontractor in the performance of this contract with Operator is listed on the Environmental Protection Agency (EPA) List of Violating Facilities. See Executive Order No. 11738 of September 12, 1973, and 40 C.F.R. § 15.20.
- (2) Prompt written notification shall be given by Subcontractor to Operator of any communication indicating that any such facility is under consideration to be included on the EPA List of Violating Facilities.
- (3) Subcontractor shall comply with all requirements of Section 114 of the Clean Air Act (42 U.S.C. § 1857) and Section 308 of the Federal Water Pollution Control Act (33 U.S.C. § 1251), relating to inspection, monitoring, entry, reports, and information, as well as all other requirements specified in these Sections, and all regulations and guidelines issued thereunder.
- (4) The foregoing criteria and requirements shall be included in all of Subcontractor's nonexempt subcontractors, and Subcontractor shall take such action as the Government may direct as a means of enforcing such provisions. See 40 C.F.R. § 15.4 & 5.

ond function of an environmental compliance clause is to provide clear notice of the applicability of the agreement's indemnification provisions.

*b. Equal Employment Opportunity Clause*

Equal employment opportunity compliance clauses now frequently appear in farmout agreements, particularly those drafted by counsel for large corporations. Federal law may well require such provisions.<sup>455</sup> Even if not required, however, they are helpful because they put the farmee on notice and clarify responsibility.

*c. Compliance with Conservation Laws*

Some farmout agreements state specifically that the farmee must comply with all conservation laws and rules. Conservation compliance language probably mirrors the expectation of the parties to the farmout agreement. After all, the farmee has the responsibility for conducting drilling and paying drilling costs. It may also remind the farmee that it cannot count on the farmor to do the things that are usually done before a well is drilled, such as check and clear title. When a conservation compliance clause is used in an agreement that makes absolute performance the standard of performance, however, failure to comply with its terms may be cause for termination of the farmee's rights.

*d. Securities Regulation*

Some attorneys counsel that farmout agreements should include an administrative clause addressing securities regulation to obtain the farmee's representation and warranty that it is a "sophisticated investor" and that it will comply with the requirements of securities laws in its dealings with farmed-out leases. While such bootstrapping techniques do not guarantee compliance, they put the parties on notice of potential problems and make clearer the responsibility for taking action to comply with applicable securities regulations.

*e. Others*

The number and length of miscellaneous administrative provisions increase as federal and state legislative branches work. A review of farmout agreements collected from major oil companies revealed that additional regulatory compliance clauses had obviously been added from time to time to cover a variety of regulatory concerns, including compliance with the Occu-

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455. The Equal Employment Opportunity Act, 42 U.S.C. § 2000e-2(a) (1982) provides:  
It shall be an unlawful employment practice for an employer

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin . . . .

The Equal Employment Opportunity Act defines an employer as a person engaged in industry affecting commerce who has 15 or more employees for each working day. 42 U.S.C. § 2000e(b) (1982).

pational Safety and Health Act,<sup>456</sup> the Rehabilitation Act of 1973,<sup>457</sup> veterans preferences, and affirmative action plans, to note only a few.<sup>458</sup>

### 11. *Dealing with Bankruptcy*

The possibility that one's business partners will go bankrupt must enter into the planning of anyone active in the oil and gas industry. When bankruptcy occurs before the drilling of the earning well or before the delivery and recording of the earned assignment, the Bankruptcy Code may undo what the farmee and the farmor have sought to accomplish in their agreement.

The farmor whose farmee files for bankruptcy is very likely to fail to achieve whatever purpose motivated it to make the agreement. While a farmee's bankruptcy trustee may drill under a farmout agreement, more likely nothing will happen until the property subject to the farmout has been tied up in bankruptcy proceedings for so long that it is too late for the farmor to drill itself or to find someone else to perform.

The farmee's position is even worse. If its farmor goes bankrupt while the farmee is conducting drilling operations under a farmout that makes drilling an option of the farmee, the farmee may face the hard choice of either walking away from its expensive hole in the ground or finishing its operations and confronting the claim of the bankruptcy trustee that he can reject the farmout agreement, and the farmee's earned right. If the farmout agreement makes drilling an obligation, the farmee must consider the possibility that the bankruptcy trustee will reject the contract and the interest earned by the farmee, even if the farmout well is drilled.

Two provisions of the Bankruptcy Code are especially troublesome. First, section 544 gives a bankruptcy trustee power to avoid any transfer or obligation voidable by a bona fide purchaser.<sup>459</sup> These so-called "strong-arm"

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456. 29 U.S.C. §§ 651-678 (1982).

457. *Id.* §§ 701-796(i).

458. As this manuscript was being prepared for the printer, the industry began using a new kind of regulatory clause in farmouts, growing out of FERC Order No. 500, 52 Fed. Reg. 30,334 (Aug. 14, 1987). Order No. 500 was adopted by the Federal Energy Regulatory Commission (FERC) to address the plight of pipelines confronted with take-or-pay liabilities. It established an interim rule requiring that a producer of natural gas that wished to use open-access transportation under FERC's rules had to offer to credit gas transported against the transporting pipeline's take-or-pay obligations under pre-June 23, 1987, gas contracts on a volumetric basis. Order No. 500 also required that the offers to credit come from the owner of the lease as of June 23, 1987, even though the lease was transferred thereafter. Thus, a farmor might be required to offer credits against its take-or-pay claims against a pipeline so that its farmee could transport gas for the farmee's account. If the farmor refused, the farmee might find itself unable to get its gas to market. Overnight, clauses clarifying the rights of the farmor and farmee began to appear in farmout agreements. Generally, such clauses stated either (1) that the farmor would offer take-or-pay credits, or (2) that the farmor would not offer such credits and specifically put the farmee on notice of its risk.

459. 11 U.S.C. § 544(a)(3) (Supp. III 1985) provides that:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by . . . a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such trans-

powers probably empower a bankruptcy trustee to set aside any unrecorded transaction. Thus, the trustee may avoid both farmout agreements structured as contracts to assign after performance by the farmee and assignments actually made but not recorded when the bankruptcy proceedings are filed.

Section 541(d) imposes possible limits upon the strong-arm powers of the bankruptcy trustee. Section 541(d) limits the interest acquired by the trustee in property in which the debtor owns only a legal interest rather than an equitable interest to the legal interest.<sup>460</sup> The legislative history suggests, however, that the intent of Congress may have been to protect only mortgages by section 541(d), and the case law is inconclusive.<sup>461</sup>

The parties can avoid the problem presented by section 544 by the relatively simple but cumbersome device of recording the farmout agreement.<sup>462</sup> Farmout agreements are almost never executed with the formalities required for recording, however. In addition, whatever their form, farmout agreements may not qualify as recordable instruments in the eyes of some recording officers. Finally, the recording fees for an extensive farmout agreement are high, and many farmers and farmees will prefer to take the risk of bankruptcy of the other rather than have the terms of their business deal spread on the record. The parties will more likely accept the recording of a memorandum of the farmout agreement. Memorandum filings are not generally done, but one commentator has urged that they become the norm and provided forms to use to do so.<sup>463</sup>

The parties cannot so easily avoid section 365, the second provision of the Bankruptcy Code that is likely to apply. Section 365 gives a bankruptcy trustee authority to accept or reject "any executory contract of the debtor."<sup>464</sup> If a farmout agreement is "executory," the trustee may reject the agreement, leaving the farmee with a successful drilling venture, but a financial disaster.<sup>465</sup> The precise meaning of "executory" is unclear. The

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fer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

460. *Id.* § 541(d) provides in part:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property . . . sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

461. See Davis, *Unassigned Oil and Gas Interest in Bankruptcy*, 22 TULSA L.J. 325, 329-34 (1987).

462. See *infra* text accompanying notes 477-81.

463. A. DERMAN PROTECTING OIL AND GAS LIEN AND SECURITY INTERESTS (A.B.A. Sec. Nat. Res. L. Monograph Series No. 6, 1987). While this monograph primarily analyzes memorandum filings for operating agreements, it also addresses the use of memorandum filings for farmout agreements. *Id.* It notes that the use of memorandum filings may also perfect interests under the Uniform Commercial Code. *Id.*

464. 11 U.S.C. § 365(a) (1982 & Supp. III 1985).

465. Disaster may be too strong a term. Arguably, § 365(i)(1) of the Bankruptcy Code, which permits a purchaser in possession under a contract "for the sale of real property" to obtain title notwithstanding the trustee's rejection of the contract, will protect the farmee in

seminal law journal article on the subject has suggested it should mean contracts "so far unperformed that the failure of either to perform would constitute a material breach excusing the performance of the other."<sup>466</sup> The Tenth Circuit has defined "executory," however, as meaning that "neither party [has] completely performed and the obligations of each [remain] complex."<sup>467</sup> By either definition, however, the typical agreement to transfer farmout structure should be subject to the powers of the trustee under section 365, until the farmee has drilled the earning well, and perhaps until the assignment is actually made.<sup>468</sup>

To avoid the application of section 365 the parties must structure the farmout agreement to conditionally assign the farmee's interest when the agreement is signed or before drilling is commenced, rather than after the well is drilled. Even this may not be enough, however. The conditions of the assignment (e.g., reversion upon failure to drill or reversion of deep rights after drilling) may be enough to keep the contract executory, since the parties will have to file title-clearing releases.<sup>469</sup> In addition, the trustee may consider a conditional assignment of the farmee's interest a "fraudulent" transfer that the trustee may set aside under section 548 of the Bankruptcy Code. Section 548(a)(2) gives the trustee authority to avoid transfers made within a year before the filing of bankruptcy for less than the reasonable equivalent sale of the property transferred when the debtor was either insolvent when the transfer took place or became insolvent as a result.<sup>470</sup> If the farmout agreement is of the typical "option to drill" variety, there is a strong

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this situation. Whether a farmout agreement is a contract subject to § 365(i)(1) is not clear, however. The argument appears particularly questionable in states like Oklahoma and Kansas, in which oil and gas leases are not clearly "real estate." See *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 699-700 (Okla. 1979) (oil and gas leases create interest in realty, but interest created is personal property, not real property, interest); see also *In re J.H. Land & Cattle Co.*, 8 Bankr. 237, 239 (W.D. Okla. 1981) (applying Kansas law that oil and gas lease is personal property in nature of profit à prendre to conclude that bankruptcy trustee possessed authority to reject lease as executory contract). In *In re Heston Oil Co.*, 69 Bankr. 34, 36 (N.D. Okla. 1986), however, a U.S. district court rejected the holding of *J.H. Land & Cattle Co.*, ruling that an oil and gas lease in Oklahoma creates a profit à prendre and an estate in real property in the nature of a fee interest and is not executory since it has been fully performed by the lessor. Even if § 365(i)(1) does not apply, the farmee would be able to assert a nonadministrative claim for damages under §§ 501 and 502. 11 U.S.C. §§ 501, 502 (1982 & Supp. III 1985). Still, the farmee that becomes entangled in the bankruptcy proceedings of its farmor is likely to lose the benefit of the risk it took.

466. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

467. *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir.), cert. denied, 414 U.S. 1068 (1973).

468. Cf. *Davis*, supra note 461, at 336-40 (discusses defining executory contract). See also Pearce, *Keeping Oil and Gas Leases Alive: A Review of Both the Mineral Lessee's Obligations and Possible Ways to Keep the Lease in Effect*, 1986 ROCKY MTN. MIN. L. SPECIAL INSTITUTE ON HARD TIMES IN THE MINERALS INDUSTRY 8-54.

469. Some bankruptcy cases suggest that a contract is executory even though the only act remaining to be accomplished under the purchase agreement is the delivery of the deed. See *Davis*, supra note 461, at 339. But see the reasoning of the court in *In re Heston Oil Co.*, 69 Bankr. 34, 36 (N.D. Okla. 1986). Is making an assignment any more onerous than defending title?

470. 11 U.S.C. § 548(a) (1982 & Supp. III 1985) provides in part:

The trustee may avoid any transfer . . . that was made or incurred on or within

argument that consideration for the transfer was inadequate, since the farmee promised to do nothing.<sup>471</sup> The inadequate consideration argument is also available when the assignment is conditional; the farmee has no binding obligation. The only sure way of avoiding treatment of the farmout agreement as an executory contract under section 365 of the Bankruptcy Code is to couple the advance assignment of the farmee's interest with a binding obligation to drill by the farmee, a structure that will often not fit the business needs of the parties.<sup>472</sup>

The farmor and the farmee may well choose to take the risk of bankruptcy of one of the parties and the intervention of the bankruptcy courts in structuring farmout agreements. Pre- and post-contract administration can lessen the risks to some degree, however. The financial stability of one's business partners is a primary consideration in whether to make a deal. Once the contract is executed, the farmee, which has the obligation to pay drilling costs and thus more to lose, should continue to monitor the fortunes of the farmor and avoid spending money or entering into binding contracts when the farmor's finances look shaky.

## 12. Terms of the Assignment

Few farmout agreements are recorded. Once an agreement has been fully performed, however, the farmee generally receives a recordable assignment of interest. When this structure is followed, it is important that the terms of the farmout agreement and the terms of the assignment not conflict, or a dispute may arise as to which prevails. *Phillips Petroleum Co. v. Stack*<sup>473</sup> illustrates this problem. In *Stack* the assignment followed the farmout agreement by a day, before the drilling of either of the two required wells. Subsequently, Stack, the farmee, refused to assign Phillips the overriding royalties on lease extensions and renewal leases that were required by the farmout, but not mentioned in the assignment. Stack contended that the agreement had merged into the assignment, or that the assignment had superseded the agreement. The Mississippi Supreme Court focused upon Stack's admission that he had been obligated to drill the two wells provided for by the farmout even though the assignment did not mention that require-

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one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily— . . . .

- (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
- (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
- (ii) was engaged in business or a transaction or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
- (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

471. Hardwick, *supra* note 226, at 6-22.

472. *Id.* at 6-21.

473. 231 So. 2d 475 (Miss. 1969).

ment.<sup>474</sup> The court concluded that the intent of the parties was that the two instruments together constituted the contract between the parties.<sup>475</sup>

The *Stack* result is not a foregone conclusion in similar fact situations, because it turned upon the Mississippi court's finding of the intent of the parties. Another court confronted with similar facts might well mechanically apply the rules of merger to conclude that the terms of the assignment prevail in the event of conflict. Both the farmor and the farmee, therefore, should pay close attention to the terms of the assignment to be certain that they are correct and complete. In the alternative, incorporating the terms of the assignment in an attached appendix can minimize the possibilities of conflict. Thus, the farmout agreement will provide merely that the assignment will be made "on the terms and conditions set forth" in the appendix.<sup>476</sup>

### 13. Recording

As discussed above, the parties do not usually record farmout agreements. They probably should. Other than the administrative expense that may be involved for the farmor to clear the record if the farmee fails to perform, which the farmor can deal with by having the farmee execute releases or reconveyances when the farmout is executed, and which at worst is no more burdensome than the routine land work of clearing title of old leases, there really is no good reason not to record the farmout or a memorandum of it.<sup>477</sup>

Recording the farmout agreement does not prejudice the farmor. Whether or not the parties record the farmout agreement, the farmor's leasehold interest is likely to be subject to mechanics' and materialmen's liens if the farmee fails to pay its bills.<sup>478</sup> A recorded agreement, however, may save the farmor's retained nonparticipating interest.<sup>479</sup>

Recording is particularly important to the farmee. One can argue that the farmee's interest ought not to require recording for protection because the

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474. *Id.* at 481.

475. *Id.* at 482.

476. *See supra* note 126.

477. *See* the discussion of memorandum filing at A. DERMAN, *supra* note 463; Morgenthaler, *Planning Ahead for a Co-Participant's Bankruptcy: A Stitch in Time*, 32 ROCKY MOUNT. L. INST. 13-1, 13-6 to -20 (1986). A simple statement that "upon request of any party, the parties hereto shall execute and acknowledge a memorandum of this Agreement in recordable form" can provide authority to file a memorandum. The parties could also execute a memorandum at the signing of the farmout.

478. *See* *Superior Oil Co. v. Etheridge*, 219 Ark. 289, 242 S.W.2d 718, 720-23 (1951); *Zone Oil & Gas Co. v. Dudley & Heath Drilling Co.*, 474 P.2d 395, 397-99 (Okla. 1970). *Cf.* *Texon Energy Corp. v. Dow Chem. Co.*, 733 S.W.2d 328, 330 (Tex. App.—Houston [14th Dist.] 1987, no writ), holding a farmor liable for drilling costs where the farmor had approved an authorization for expenditure and executed an operating agreement. *But see* *Dews v. Halliburton Indus., Inc.*, 708 S.W.2d 67, 70 (Ark. 1986), holding that a farmor is not liable either for legal or equitable liens upon the leasehold as a result of a farmee's default.

479. *See* *Zone Oil & Gas Co. v. Dudley & Heath Drilling Co.*, 474 P.2d 395, 399 (Okla. 1970). In *Zone* the court refused even to consider the argument that *Zone's* production payment was not subject to the lien because the parties had not recorded the conveyance in which the payment was reserved. *Id.*

practice of not recording farmouts is so well established that third parties should be placed on inquiry notice of the possibility of their existence. One may assert that the farmee's possession of the property under a farmout agreement should put others on notice of its claims. These arguments are tenuous and dependent upon particular facts, however.<sup>480</sup> The surest way for the farmee to protect its rights is by recording. In many states, recording puts third parties on notice of the provisions of unrecorded agreements referred to in the recorded instrument, as well as of the terms on the record.<sup>481</sup>

## V. CONCLUSION

The review of more than one hundred example farmout agreements, and discussions with dozens of lawyers incident to the preparation of this Article, have largely confirmed the author's personal preconceptions about farmout agreements. First, the structure of farmout agreements is very much a function of tax rules. Farmout agreements are business agreements entered into by people who seek to make a profit, and compliance with the tax rules often makes the difference between profit and loss in our society. All farmout agreements reviewed were obviously drafted with an eye to giving the farmee the full benefit of the intangible drilling cost deduction. Concern with other tax issues was also apparent.

Second, although the tax structure of farmout agreements is very much the same, their substantive provisions vary widely. In part, the difference in substantive provisions is reflexive; once a company has been burned by a particular problem, it drafts to avoid it in the future. In part, also, the wide variety of substantive provisions in farmout agreements reflects the vitality of American businessmen and their lawyers. "Dealmaking" is often every bit as important in whether or not a venture is profitable for both of the parties as the underlying value of the properties farmed out. The agreements reviewed reflected the high creativity index of the oil and gas industry.

Finally, however, farmout agreements are susceptible to orderly analysis, and not enough attention is given to that analysis. Understanding the purposes that may lead the farmor or the farmee to enter into a farmout agreement, the essential provisions that the agreement must contain to achieve those goals, and the alternatives available to the draftsman are the keys to successfully preparing or analyzing a farmout agreement. The goals of each of the parties will determine how the agreement will be put together and what provisions will be emphasized. The essential provisions of an agree-

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480. See *O'Kane v. Walker*, 561 F.2d 207, 209 (10th Cir. 1977). In *O'Kane* the court held that a conveyance for a low, but not unreasonably low, price was not sufficient to put the purchaser on inquiry notice. *Id.* The case also contains an excellent discussion of when inquiry notice is given. *Id.* at 208-09; see also Hill, *Title Repositories, Recording, and Constructive Notice*, 29 ROCKY MTN. MIN. L. INST. 469, 477 (1983).

481. See *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 905 (Tex. 1982). In *Gulf Oil Corp.* the court held that an assignment gave notice not only of the operating agreement referred to in the assignment, but also to farmout agreements referred to in the operating agreement. *Id.*; see also *Pasternak v. Lear Petroleum Exploration, Inc.*, 790 F.2d 828, 830 (10th Cir. 1986) (farmee bound by terms of operating agreement referred to in its farmout agreement).

ment are those without which any farmout agreement will be incomplete. Drafting alternatives help keep the agreement flexible and responsive to the parties' needs.

The aim of this Article has been to develop an analysis of the purposes and essential considerations of a farmout, and to collect alternative provisions that may be of use to the draftsman. In a sense, this Article is unfinished. It will never be finished, because only the creativity of businessmen and their lawyers limits the variety of provisions that may be included in a farmout agreement.