
Oil & Gas Law

Class 23:

Lessee Contracts (2 of 4): Farmout Agreements

Last Time / Tonight ...

■ LESSEE TRANSFERS

- Assignments of the Oil & Gas Lease
- Farmout Agreements
 - Drilling Obligations
 - Retained / Earned Interests
- Joint Operating Agreements

Farmout Agreements – Intro

- **Definition?**
- Background
 - Increased use since WW II
 - Letters → Formal (and quite detailed) Agreement
- Parties
 - Lessor →→ Lessee / **Farmor** →→ **Farmee**

Farmout Agreements – Intro

- *Why would parties do this kind of deal?*
- **Parties' Reasons: Farmor**
 - ❑ Lease preservation where Farmor won't / can't drill before expiration of Primary Term
 - ❑ Lease salvage
 - ❑ Obtain geologic data
 - ❑ **Risk sharing**
 - ❑ Participation w/out cost
 - ❑ Add to reserves
- **Parties' Reasons: Farmee**
 - ❑ Add acreage w/o leasing
 - ❑ Become active in new area / play
 - ❑ **Risk sharing**
 - ❑ Access to a prospect that Farmor (larger company?) liked

Farmout Agmts – Key Issues

- 1. What acreage is affected:
 - depths / formations; plus an AMI?
- 2. What kind of duty is imposed
 - option or obligation; number of wells required
- 3. The “earning” factor
 - drill-to-earn (D-t-E), or produce-to-earn (P-t-E)
- 4. Kind of interest / how much being earned
- 5. Form of the Agmt
 - agreement to transfer, or conditional assignment
- 6. Relationship btwn OGL and FO Agmt
- 7. “Legal stuff”

Farmout Agreements – Structure & Characteristics (1 of 4)

- **1. CHAR #1: Acreage affected**
 - Recital / Ex. 1 & XXXIII: Define acreage [+ AMI?]
- **2. CHAR #2: Kind of Duty – option or obligation** – *which kind is this?*
 - Art. I – initial well → NOTE: “actual drilling”
 - Art. II & III – additional & substitute wells
 - Art. I – complete initial well w/in 90 days
 - *Why is this needed / desired?*
- **3. CHAR #3: Earning Factor – D-t-E, or P-t-E**
 - *Art. IV – which kind is this?*

Farmout Agreements – Structure & Characteristics (2 of 4)

- **4. What does the Farmee pay? get?**
 - ❑ Art. IV & X – F’ee pays initially (incl. Min. Roy. / Shut-In Royalty)
 - ❑ Art. V – After well drilled, F’or assigns to F’ee XX% and retains an ORR
 - ❑ Art. VI – F’ee recovers costs until “payout”
 - ❑ After payout, F’or has a decision: keep ORR or convert to a Working Interest

Farmout Agreements – Structure & Characteristics (3 of 4)

■ 5. Form of Assignment

- 2 types: agreement to transfer vs. conditional assignment
- *Art. IV – which kind is this?*

■ 6. Liability / Risk Mgmt.

- Art. VIII – default
- Art. XX / XXI – liabilities and indemnities

■ 7. Relationship between Lease and FO Agmt

- Art. XI & XII – Farmee **CANNOT** give back the OGL (incl. performance of all Lease covenants, express **OR** implied)
- Art. XIV – “Extensions and Renewals” clause

Farmout Agreements – Structure & Characteristics (4 of 4)

■ 8. Other provisions

- ❑ Art. XIII – Farmor's concurrent access rt. → different depths
- ❑ Art. XVIII – Farmee gives Farmor data
- ❑ Art. XVI – if Farmor elects to convert its interest (after Payout) to a WI, the FO converts to a JOA
- ❑ Art. XXIV / XXV – Farmee's Limited Transfer Rts.
 - -- Farmee needs Farmor's consent to assign
 - -- Pref. Rt.

FO Agmts – Martin v. Darcy

■ Facts

- Consents needed to assign; obtained 2 days before deadline
- *Is Darcy's obligation a covenant or condition?*

■ *Issue?*

■ Measure of Damages

- OK: cost of drilling the well
- TX: “lost royalty” rule – the \$ F’or lost by well not being drilled ... **BUT** heavy burden of proof
- *Ct?*

■ See FO Form Art. VIII for modern approach

FO Agmts – Retained Interests

- P. 976: F'or typically retains an ORR
 - ❑ Stated percentage, or diff. between a specific percentage and other royalties
- PLUS right to convert to a working interest
 - ❑ On a well-by-well basis?
 - ❑ Lease basis?
 - ❑ What happens if the leased acreage is pooled?
 - ❑ How to define “payout”, and how does F'or know if / when it happens?

Calculation of “Payout”

- assume the Payout Cl. in the FO Agmt. Form:
- 1. Farmee drilling well and well blows out; Farmee recovers \$2 MM insurance proceeds but can also charge its costs of controlling the blowout, cleaning up the site and re-working the well against the sale proceeds
- Continental Oil Co. v. American Quasar Petroleum Co., 599 F.2d 363
- 2. Farmee receives \$4.00 / MMBtu under a prior long-term sales contract, when other producers in the area are receiving \$7.00 / MMBtu → same issue as under the OGL

FO Agmts – Earned Interests

- P. 977: F'ee earns negotiated interest in the drillsite proration unit acreage
 - Additional wells = additional acreage

FO Agmts – Land Descriptions

- AMI clause in Ltr. Agmt assigning F'ee's rts; assignment refers to unrecorded Op. Agmt, FO Agmt and Ltr Agmt
- Westland: 3 issues
 - were Gulf and Superior on “notice” about Westland's (& C&K's) prior but unrecorded FO letter w/ Mobil?
 - whether Nov. 15, 1966 ltr agmt. contained a legally sufficient land description?
 - was the AMI between Westland and C&K a personal covenant between them, or a covenant “running with the land”?
- **What if** the Nov. 15, 1996 letter agmt. had not contained the AMI provision, but had instead referred to another document (and another, and another after that)? **How far does the notice requirement go?** → **2 steps: chain + other facts/docs implied**
- **Lesson learned:**
 - Between land descriptions, prior agreements, and royalty percentages, make sure that the descriptions are so basic that there's no question what parties' obligations are

NEXT...

■ **JOINT OPERATING AGREEMENTS (JOAs)**

■ =====

■ **TU., April 15: Operational Issues**

- Ch. 6, Sec. E 1 & 2 (pp. 998 – 1023)
- **+ SUPP. MATERIALS** → **JOA Form; Costs;**
Exculpatory Clause

■ **TH., April 17: Mktg / Gas Bal. / Pref. Rts.**

- Ch. 6, Sec. E 3 and 4 (pp. 1023 – 1038)
- **+ SUPP. MATERIALS** → **3 cases** re gas
balancing & pref rts
- **BRING JOA FORM TO CLASS AGAIN !!!**