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SOMETHING OLD, SOMETHING NEW: THE EVOLVING FARMOUT AGREEMENT

by

Professor Kendor P. Jones

I. INTRODUCTION

The three most important instruments for oil and gas development have been and continue to be the oil and gas lease, the joint operating agreement and the farmout agreement. Of the three, the lease is by far the most senior[1] and it has received the most analysis by commentators and the courts. However, as Professor Lowe notes in his comprehensive article on farmout agreements[2], since the end of World War II, the oil and gas farmout has become nearly as important as the oil and gas lease, in part, he believes, as a reaction to the increased risks and costs of deeper drilling and in the proliferation of small oil companies anxious to make deals with their larger brethren.[3] This paper will define a farmout agreement and will review the basis for its structure, i.e., the goals of the parties and applicable tax law. Then it will address selected issues involving farmouts, with an emphasis on recent cases. Finally, it will consider the evolution of the farmout agreement from the simple, one or two page document that was first used by the parties to the complex, multi-paged, multi-faceted document that is the rule today and it will raise the question whether the fundamental relationship of farmor/farmee for oil and gas development under a farmout agreement has changed as the result of new technology, emerging shale plays and a challenging economic environment

II. DEFINITION

An oil and gas farmout agreement has been defined as "an agreement by one who owns drilling rights to assign all or a portion of those rights to another in return for drilling and testing on the property".[4] The entity that owns the drilling rights is the "farmor", while the entity that receives the right to drill is the "farmee."[5] A farmout agreement differs from an operating agreement in that under a farmout agreement the farmee is seeking to earn an interest in the farmor's lease, while the parties to an operating agreement already own joint interests in a lease or leases or in the contract area and agree to combine these interests for joint operations.[6] Another distinction is that the farmee "carries" the farmor for all or a part of the costs to drill the well, while the parties to an operating agreement share such costs "heads up."[7]

III. STRUCTURE

A. Purposes of the Parties. The parties' goals for entering into a farmout agreement and the tax rules applicable to the farmout agreement dictate the structure of the farmout, although, as discussed in Section V, the author believes that in the current environment, the former governs over the latter. The farmor may have a variety of reasons for wishing to farmout its interest. Professor Lowe has identified[8] seven factors that may motivate the farmor, including (i) lease preservation; (ii) lease salvage (i.e., monetizing a prospect that the farmor has condemned); (iii) risk sharing; (iv) obtaining geological information to evaluate other leases held by the farmor or to delineate a "play"; (v) access to the farmor's market (perhaps not as significant in an era of deregulation and hedging); (vi) obtaining reserves (again, less important today since the pipelines no longer are concerned about gas shortages and there seems to be ample oil available to refiners); and (vii) drilling an "obligation well" (e.g., a well required to prevent drainage, to further develop the leasehold or to prevent the application of a Pugh clause).

The factors Professor Lowe has identified[9] that may motivate the farmee's decision to enter into a farmout include (i) quickly acquiring an acreage position or obtaining reserves; (ii) using available cash, equipment or personnel (particularly if the farmee or its affiliate is a drilling services company); (iii) a positive evaluation of a prospect that the farmor has dismissed; and (iv) a desire to become active in the area, but also to share the risks.

B. Applicable Tax Rules. In the interest of brevity, this paper will not address in detail the tax treatment of farmout agreements.[10] The following discussion will summarize such tax treatment. A farmout agreement is a form of "sharing arrangement." The essential feature of such an arrangement is that one party makes a contribution to the acquisition, exploration or development of an oil and gas property for which it is given a share of the production from the property to which the contribution is made.[11] The contribution may be of acreage, money, goods or services, while the share of production transferred may be a working interest, a carried or net profits interest, an overriding royalty or a production payment.[12] The contribution must be to the property in the production of which the contributor is given an interest and, if the contribution is in money, it must be made or agreed to before the costs have been incurred.[13]

The contributor in a sharing arrangement has made a capital investment and it acquires a depletable interest in the production.[14] Neither the contributor nor the recipient realizes taxable income or loss from the contribution or transfer, because the transfer of a property interest for development is treated as the formation of a new economic venture, rather than a sale of property or services.[15] If, as is the case with most farmouts, the farmee receives an operating interest for its contribution, the tax consequences depend on whether the entire operating interest or an undivided share of such interest is transferred to the farmee. When the farmee receives the entire working interest, it may deduct all of the intangible drilling costs ("IDCs")[16] it pays to drill and complete the well against current income, so long as there is no possibility that the

farmee's working interest in the drillsite acreage will end before the complete payout of the costs of drilling, completing and operating.[17] The IDC deduction is a very important incentive to the oil and gas industry since IDCs typically amount to between 50% and 80% 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.[18]

In 1977 the IRS changed the rules of the game for farmouts with Revenue Ruling 77-176. It 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. The IRS treated the interest in the acreage outside of the well site acreage as a separate transfer subject to tax since the farmee made no contribution to the development of the outside acreage. Therefore, the farmor realizes taxable income equal to the difference between its basis in the outside acreage assigned and the fair market value of such acreage and the farmee is deemed to have received taxable income equal to the fair market value of such outside acreage since it made no capital investment in such acreage. Thus both parties realize "phantom income" from the transaction.[19] There are a variety of devices that avoid or minimize the impact of Revenue Ruling 77-176.[20] The most popular of these is the tax partnership, which uses IRC Section 721 to designate both the well site acreage and the additional acreage as the "property" of the tax partnership. The parties accomplish this designation by agreeing in the farmout agreement not to elect out of Subchapter K of the Internal Revenue Code and agreeing to allocate income and deductions on a partnership return.[21]

IV. SELECTED ISSUES

Oil and gas practitioners have not standardized farmout agreements to the degree that they have the joint operating agreement and the oil and gas lease. Early farmout agreements tended to be on the basis of informal "letter agreements," often on a single page or two, that failed to address or fully express many key areas. Often the "agreement" consisted of an exchange of letters that may or may not have constituted a binding contract.[22] The farmout agreement also must sufficiently describe the land that is subject to the agreement to meet the standards of the statute of frauds. For example, in Westland Oil Development Corp. v. Gulf Oil Corp.[23], an area of mutual interest clause in an assignment of the farmee's rights under a farmout agreement provided that if any of the parties acquired any additional leasehold interests affecting "the lands covered by said farmout agreement" or "under lands in the area of the farmout acreage", the interests acquired would be subject to the provisions of the AMI. The court held that the reference to the lands covered by the farmout agreement satisfied the statute of frauds since the farmout agreement contained a description of the lands subject to the leases, but that "lands in the area of the farmout acreage" did not satisfy the statute.[24]

The parties to the farmout agreement must be cognizant of the provisions in the leases assigned. For example, in Isler v. Texas Oil & Gas Corp.[25], the agreement provided that the farmor would make delay rental payments on the federal lease assigned or would give the farmee notice before ceasing to make them. But it further provided that the farmor would have no responsibility to the farmee for failure to make such

payments. The farmor, through oversight, failed to make rental payments and the lease expired. The farmee drilled two wells on the lease before it learned that the lease had expired. It sued the farmor for breach of contract and on a tort theory. The Tenth Circuit reversed a jury award for the farmee, holding that the exculpatory provision in the farmout agreement meant what it said.[26]

A number of recent decisions have demonstrated the importance of careful drafting when preparing the farmout agreement. For example, in EOG Resources, Inc. v. Wagner & Brown, Ltd.[27], the court held that the earning provision in the farmout agreement that referred to "100 feet below the deepest producing interval" referred to the vertical depth of the test well rather than the producing geological formation. Similarly, in Osborn v. Anadarko Petroleum Corp.[28], the court held that the conversion of an oil and gas well from extraction to water injection for purposes of secondary recovery operations did not constitute "abandonment" of the well that allowed an overriding royalty owner to convert to a 50% working interest in the interest earned by the farmee.[29]

A re-occurring issue in litigation involving farmouts is the duty owed the farmor by the farmee. In Energen Resources MAQ, Inc. v. Dalbasco[30], the court held that even though the farmout agreement was silent on the matter, the farmee had breached its duty to notify the farmor that it intended to cap the well since industry custom and useage required such notice. Also, in Amoco Production Company v. Texaco, Inc., et al.[31], the court upheld a $30,000,000 damage award to the farmor for the farmee's failure to give the farmor prior notice before allowing the leases to expire in breach of the farmout agreement.[32]

Another fertile area for litigation involving farmouts is the calculation of "payout." For example, in Continental Oil Company v. American Quasar Petroleum Co. of New Mexico, Inc.[33], the court held that all expenses incurred as a result of a well blowout were recoverable by the farmee through the payout account notwithstanding that the risk had been covered by insurance, since blowout insurance was not required by the farmout agreement and the premiums would not have been a recoverable cost under the agreement.[34]

An interesting case that was recently argued before the Wyoming Supreme Court, Doyle and Margret M. Hartman, et al. v. Ultra Resources, Inc., et al.[35], while dealing with a document styled as "Agreement for Assignment", involves the same issues that would be the case if it was a farmout agreement. In Hartman, plaintiffs' predecessor-in-interest assigned leases covering approximately 6,000 acres to defendants' predecessors-in-interest to be committed to the 90,000 acre Pinedale Unit which was approved by the USGS in 1954, shortly after the assignment. The assignor retained a net profits interest ("NPI") of 5% on the net profits from unit operations. The Pinedale Unit was terminated by the BLM in 1981, but many of the original leases were committed to successor units. The Pinedale Unit, which consisted primarily of shallow gas wells, never produced a profit, but beginning with the deeper gas discoveries in the late 1990s and as a result of higher gas prices, the NPI, if it continued to exist with respect to the originally committed leases, became quite valuable. The issue argued before the court was whether the

agreement creating the NPI terminated with the termination of the Pinedale Unit or, as the district court held, it continued to apply to the originally committed leases.

V. EVOLUTION OF THE FARMOUT AGREEMENT

As stated in the Introduction, early farmout agreements were generally quite brief and might consist of an exchange of telexes.[36] Today's farmout agreement is likely to be far more complex and far-reaching.[37] In the current environment, the majors generally are not interested in entering into farmout agreements, as either farmor or farmee, unless it involves a significant shale play, and they use farmouts to reduce risk in the early stages of such a play.[38] Even when they agree to farmout a lesser interest or a smaller project which may not meet their economic hurdles, they are likely to want a permanent override that is not convertible to a back-in, because there are not enough dollars involved to justify the administrative costs of tracking the payout account and they do not want the liability for plugging the well. For a shale play, the majors are likely to want to be carried to casing point or to the tanks, so that they can have immediate participation, assuming that they control or have the ability to control a large percentage of the play. Their goal in such a case is to obtain well information. There is great reluctance to farm out a play that has not been delineated, since they might be farming out the "sweet spot"; instead they want to farmout acreage that will help to identify such sweet spot.

Today's farmout agreement is likely to focus on risk management concerns as much as the key characteristics of traditional farmout agreements.[39] A contemporaneous farmout agreement is likely to have detailed provisions dealing with bonding and insurance requirements, and with environmental protection, including specific mitigation requirements, and it may require the farmee to escrow funds to cover its obligations. In the current economic environment, the tax advantages of farmouts do not appear to be as important as they once were. The ability to deduct IDCs from current income does not seem to provide the same incentive for development as did the tight gas sands tax credits. Farmout agreements have become so complex and so multi-faceted that they are often preceded by a letter of intent that can take longer to negotiate and be more detailed than traditional farmout agreements. Thus, if a company's leases have three-year primary terms and it may not drill the prospect itself, it is likely to begin to seek a farmee/partner at the end of the first year of the lease term, given the time it will take to negotiate the farmout and get everything in place to drill the earning well.

Even with today's de-emphasis of traditional farmouts in favor of participation and joint venture agreements where the parties combine their resources to jointly develop the prospect, there are still the Marvin Davis type promoters working the oil patch, i.e., aggregate substantial leasehold, develop the properties with someone else's money and retain a fat override or a 100% carry, but if they wish to land a mullet in today's economic environment with uncertain commodity prices, they had better be prepared to lower their expectations on what they will get in return.

FOOTNOTES:

[1] The lease under which America's first well, the Drake well, was drilled was dated December 30, 1857. The first AAPL Model Form Operating Agreement was published in 1956. There is no certainty when the first farmout agreement was entered into, but one commentator asserts that the term "farmout" was first used by a court in Petroleum Fin. Corp. v. Cockburn, 241 F.2d 312 , 313 n.2 (5th Cir. 1957). See *Cage, The Anatomy of a Farmout*, 21 INST. ON OIL & GAS L. & TAX'N 153-54 (1970).

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

[3] *Lowe* at 762.

[4] *Id.*

[5] The origin of the term "farmout" is not clear. Professor Hemingway has said that the term dates back to Roman times when the state transferred the right to collect taxes to private individuals who received a fee for their services, while other commentators have attributed the term to that used in baseball when a rookie ballplayer may be farmed out to a minor league team for further seasoning. *Lowe* at 763.

[6] See *Lowe* at 764.

[7] *Id.*

[8] *Lowe* at 778-782.

[9] *Lowe* at 782.

[10] For a detailed analysis of the tax treatment of farmouts, see the following: *Martin and Kramer, William & Meyers Oil and Gas Law* §§ 432.3-433.1 [2008] ("*Williams & Meyers*"); *Polevo and Smith, Federal Taxation of Oil and Gas Transactions*, ch. 10 (1989); and *Lowe*, n. 2, at 765-79.

[11] *Williams & Meyers* § 433.

[12] *Id.*

[13] *Id.*

[14] See G.C.M. 22730, 1941-1 C.B. 214

[15] See *P. Maxfield and J. Houghton, Taxation of Mining Operations* §§9.01-05 (1989).

[16] IDCs include the costs of wages, fuel, repairs, hauling and supplies used in drilling, fracturing and cleaning the well, site preparation and construction of derricks, tank and pipelines necessary to prepare the well for production. See *C. Russell & R. Bowhay, Income Taxation of Natural Resources* § 14.12 (1986).

[17] See Rev. Rul. 80-109, 1980-1 C.B. 129.

[18] See *Russell & Bowhay*, n. 16, § 14-11-A.

[19] See *Lowe*, n. 2, at 769-70.

[21] See *Lowe* at 771-78.

[21] See *Lowe* at 777.

[22] See, generally, *Tower, Enforceability of Letters of Intent and Other Preliminary Agreements*, 24 ROCKY MTN. MIN. L. INST. 347 (1978). Compare Getty Oil Co. v. Blevco Energy, Inc., 722 S.W.2d 51 (Tex.App. 1986) (parties never reached a "mutually acceptable agreement") with Chevron v. Martin Exploration Co., 447 So.2d 469 (La. 1984) (binding contract despite its designation as "preliminary").

[23] 637 S.W.2d 903 (Tex. 1982).

[24] See also Stekoll Petroleum Co. v. Hamilton, 255 S.W.2d 187 (1953).

[25] 749 F.2d 22 (10th Cir. 1984).

[26] See also Davis v. Zapata Petroleum Corp., 351 S.W.2d 916 (Tex.App. 1961) (farmout agreement did not take into account lease provision that prohibited cessation of drilling operations).

[27] 202 S.W.3d 338 (Tex. App. 2006).

[28] 996 P.2d 9 (Wy. 2000).

[29] See also Sawyer v. Guthrie, 215 F.Supp.2d 1254 (D.Wy. 2002), where the court held that the farmee had no contractual duty to continuously develop the leasehold so that no part of the lease would be allowed to expire.

[30] 23 S.W.3d 551 (Tex. App. 2000).

[31] 838 So.2d 821 (La. App. 2003).

[32] See also EOG Resources, Inc. v. Hanson Production Co., 74 S.W.3d 697 (Tex. App. 2002), where the court held that the farmout agreement and the subsequent

assignment had to be read together to determine the parties' intent as to whether the farmor's retained override burdened extensions and renewals of the subject leases.

[33] 599 F.2d 363 (10th Cir. 1979).

[34] See also Mengden v. Peninsula Production Co., 544 S.W. 643 (Tex. 1976).

[35] Decision pending, S-08-0262. (Hartman is one of seven cases consolidated on appeal by the Wyoming Supreme Court and argued on May 14, 2009).

[36] See, e.g., Petroleum Financial Corp. v. Cockburn, 241 F.2d 312 (5th Cir. 1957), where the court held that the "contract", as evidenced by an exchange of telegrams, was so ambiguous as to permit introduction of parol evidence that established that there was no breach.

[37] A good example of this type of agreement is found in Amoco Production Co. v. Hugoton Energy Corp., 11 F.Supp.2d 1270 (D.Ks. 1998), where the farmout covered the farmor's leasehold interests in five counties, which were divided into ten nine-section drilling blocks, for the drilling of exploratory wells and development wells.

[38] The author wishes to thank James J. O'Malley, Land Director-U.S. Onshore Exploration for Anadarko Petroleum Corporation, for his assistance with this section.

[39] Professor Lowe has identified five such key characteristics of a traditional farmout agreement: (i) the duty imposed (option or obligation), (ii) the earning factor (produce to earn or drill to earn), (iii) the interest earned (divided or undivided interest or combination), (iv) the number of wells to be drilled (single or multiple well farmout), and (v) the form of the agreement (agreement to transfer or conditional assignment).