

Anatomy of a Farmout Agreement

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Parties

Farmor:

Company who owns the drilling rights to the untested area of the land to be explored

Farmee:

Company willing to bear the cost, risk, and expense of drilling a test well in exchange for drilling rights

“an agreement by one who owns drilling rights [farmor] to assign all or a portion of those rights to another [farmee] in return for drilling and testing on the property”



Farmout Agreement vs. Joint Operating Agreement

Farmout Agreement

An agreement describing how a third-party may earn a working interest in a well, lease, or unit; may precede the execution of a Joint Operating Agreement*

Joint Operating Agreement (JOA)

A joint operating agreement governs the relationship between working interest owners in the well, lease, or unit.

*Farmout Agreements may require the farmor and farmee enter into a JOA; often with one attached to the Farmout Agreement



Incentives

Farmor

Farmee

Lease Preservation



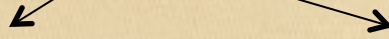
Quickly acquire acreage

Lease Salvage



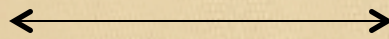
Utilize capital, time

Shift drilling costs



Operating Advantage

Obtain Information



Operate in new area



Basic Structure

Common Clauses

Identify Subject Lands

Drilling of Test Well(s)

- a. Location
- b. Depths

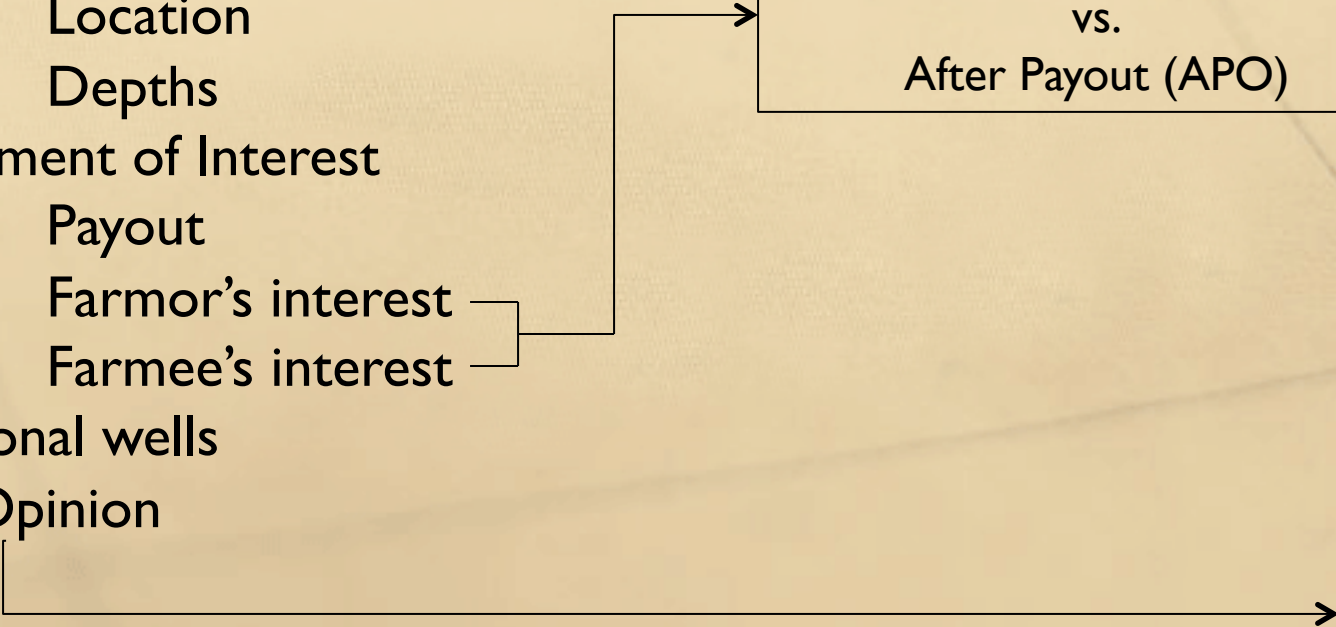
Assignment of Interest

- a. Payout
- b. Farmor's interest
- c. Farmee's interest

Additional wells

Title Opinion

Before Payout (BPO)
vs.
After Payout (APO)



Earned Interest Basis

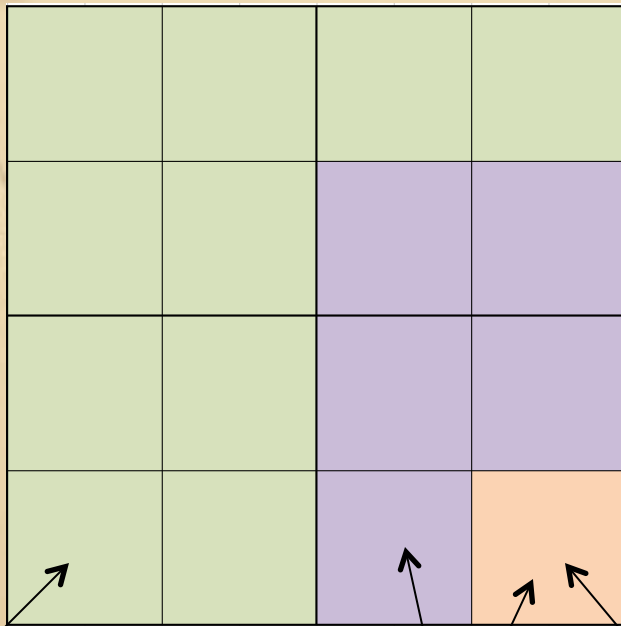
On what basis does the Farmee earn a working interest?

- Wellbore
- Leasehold
- Drilling and Spacing Unit



Earned Basis – Partial Leasehold

At Execution

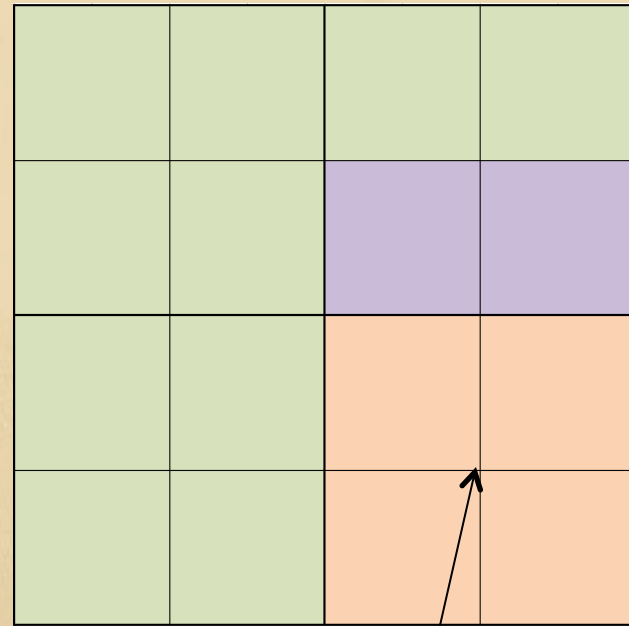


Outside Farmout

Oil and Gas Lease

Subject to Farmout

After Test Well



Expanded leasehold subject to farmout

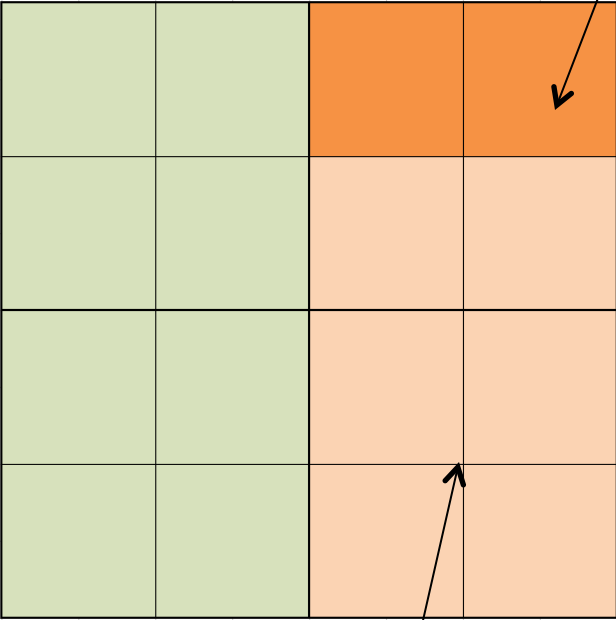
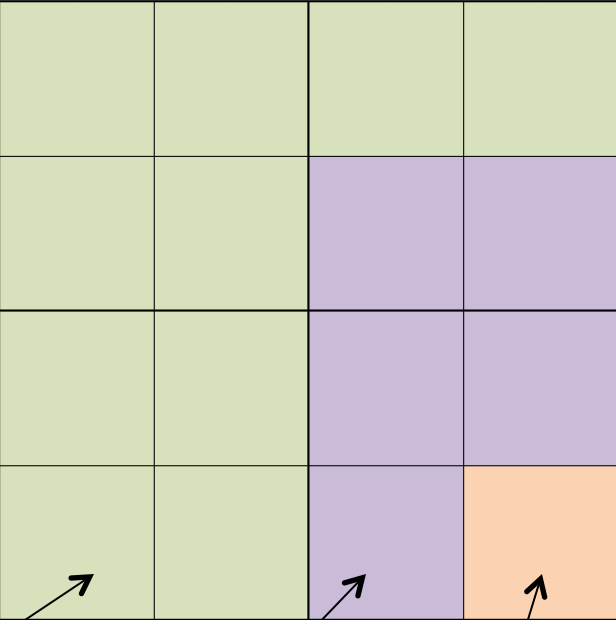


Earned Basis – Drilling Unit

At Execution

Lease #2

After Test Well



Outside Farmout

Oil and Gas Lease #1

Subject to Farmout

Lease #1 – all covered by Farmout
Lease #2 – covered as part of unit



Drilling of the Test Well

Duty to drill?

Option Farmout
-may drill-

Obligation Farmout
-must drill-

**Production
required?**

Drill to Earn

Produce to Earn



Payout – What’s Included?

“Payout shall be that point of time when the gross value of all production attributable to [Farmee’s 65%] working interest, prior to the payment of any taxes, equals [Farmee’s] **cost of drilling, completing, equipping and operating** the test well...”

Costs of Payout

- drilling
- operating
- equipping
- completing

Also?

- secondary recovery costs
- regulatory fees
- costs of accidents



Payout – BPO vs. APO

Before Payout (BPO)

Farmor:

WI – 0%

Farmee:

WI – 100%

After Payout (APO)

Farmor:

WI – 35%

Farmee:

WI – 65%

“Back-In Interest”

Working Interest (WI)



Payout – BPO vs. APO

Before Payout (BPO)

Farmor:

WI – 0%

ORRI – 1%

Farmee:

WI – 100%

After Payout (APO)

Farmor:

WI – 25%

ORRI – 0%

Farmee:

WI – 75%

Working Interest (WI)
Overriding Royalty Interest (ORRI)



Convertible ORRIs

Convertible on a Well-by-well basis

		x	x
		x	x

Outside Farmout

Subject to Farmout

Convertible against all wells

		x	x
		x	x



Convertible ORRIs

Convert ORRI across all wells

Farmor:

BPO: 1.0% ORRI

APO: 25% WI

Convert ORRI well-by-well

Farmor:

#1 - BPO: 1.0% ORRI

#1 - APO: 25% WI

#2 - BPO: 1.0% ORRI

#2 - APO: 1.0% ORRI

#3 - BPO: 1.0% ORRI

#3 - APO: 25% WI



		2	1
		3	4

Outside Farmout

Subject to Farmout

Taxes – Sharing Agreement

Before Payout (BPO)

Farmee can deduct
Intangible Drilling Costs
from their current income
up to their Working
Interest in the well

Example

Farmee bears the costs, but
limited to WI of <100%

After Payout (APO)

Proceeds of production
taxed as income

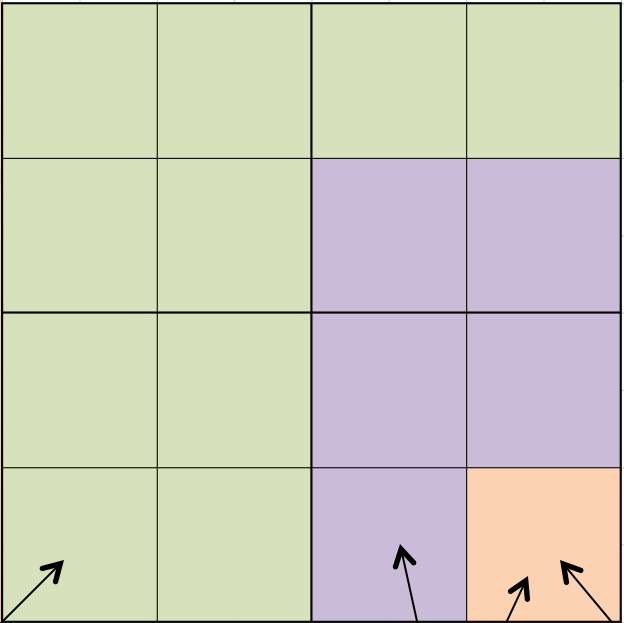
IDC – costs to drill and
complete a well that are
not a part of the final
operating of the well,
other than depreciable
assets

Working Interest (WI)
Overriding Royalty Interest (ORRI)



Sharing Agreement

At Execution

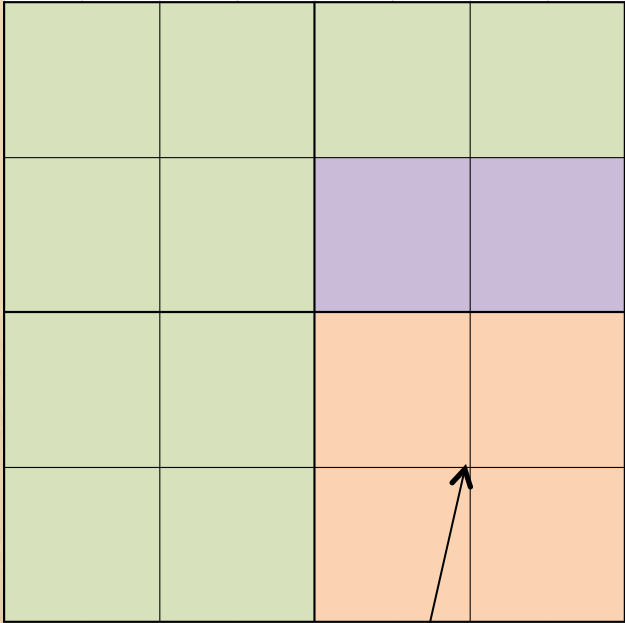


Outside Farmout

Oil and Gas Lease

Subject to Farmout

After Test Well



Expanded leasehold subject to farmout



Legacy Burden of Older Farmouts

- Tendency for inadequate drafting
- Payout can take a long time
 - Lingering notice obligations
- After-payout calculations can be tricky
- Lack of recording may create an enforceability conundrum



Example I: Mixed Convertible & Non-Convertible Overrides

- The Farmout Scenario:
 - Farmor Owns 100% of WI at Time of Farmout
 - 100% WI Assigned in DSU Before Payout
 - 3% Override Reserved, Convertible to 50% WI After Payout

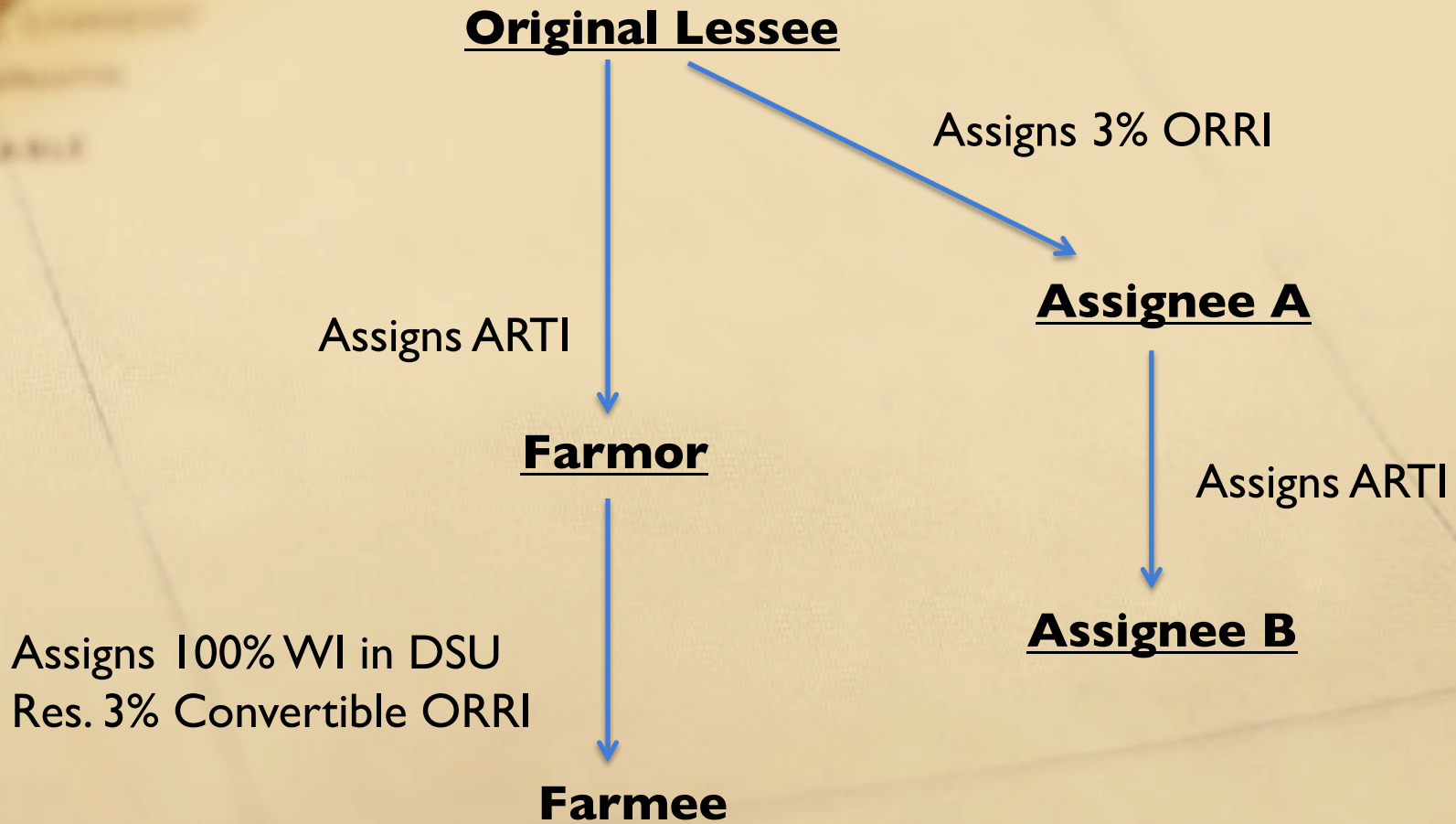


Example I, Continued

- The BPO Ownership Picture:

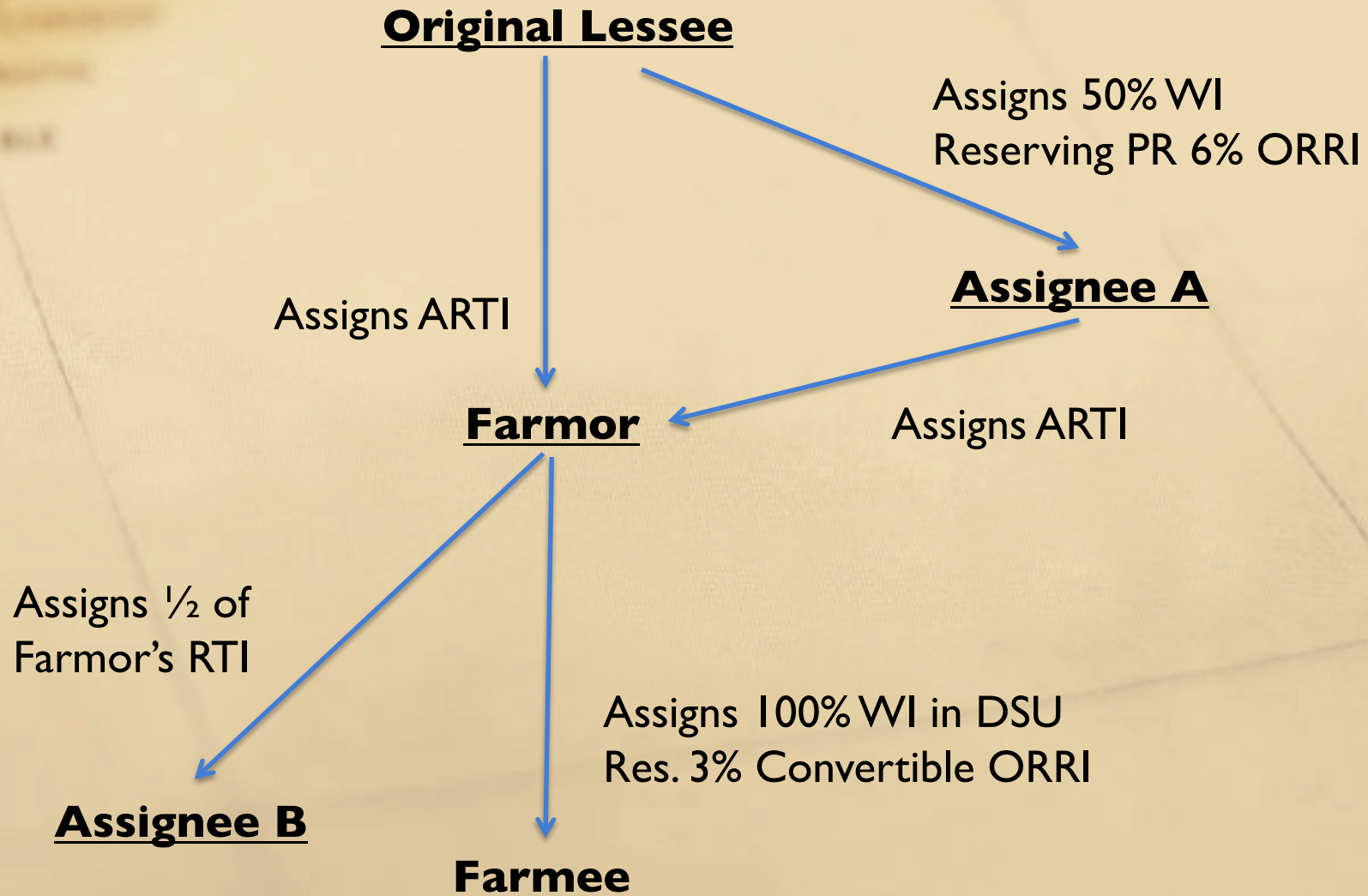
Owner	% Interest	Interest Type
Landowner	12.5%	Landowner Royalty
Assignee B	3%	Override
Farmor	3%	Override
Farmee	100%	Working Interest
	81.5%	Net Revenue Interest

Title Chain I: The Intuitive Case



ARTI = All Right, Title, & Interest

Title Chain 2: Looks Can Be Deceiving



ARTI = All Right, Title, & Interest

Example 1: Impact on APO Owners

Title Chain 1

Owner	% Interest	Type
Landowner	12.5%	Landowner Royalty
Assignee B	3%	Override
Farmor	50% 42.25%	Working Int. Net Revenue
Farmee	50% 42.25%	Working Int. Net Revenue

Title Chain 2

Owner	% Interest	Type
Landowner	12.5%	Landowner Royalty
Assignee B	1.5% 25% 21.125%	Override Working Int. Net Revenue
Farmor	1.5% 25% 21.125%	Override Working Int. Net Revenue
Farmee	50% 42.25%	Working Int. Net Revenue

Example 2: Only Part of Working Interest Burdened By Convertible Override

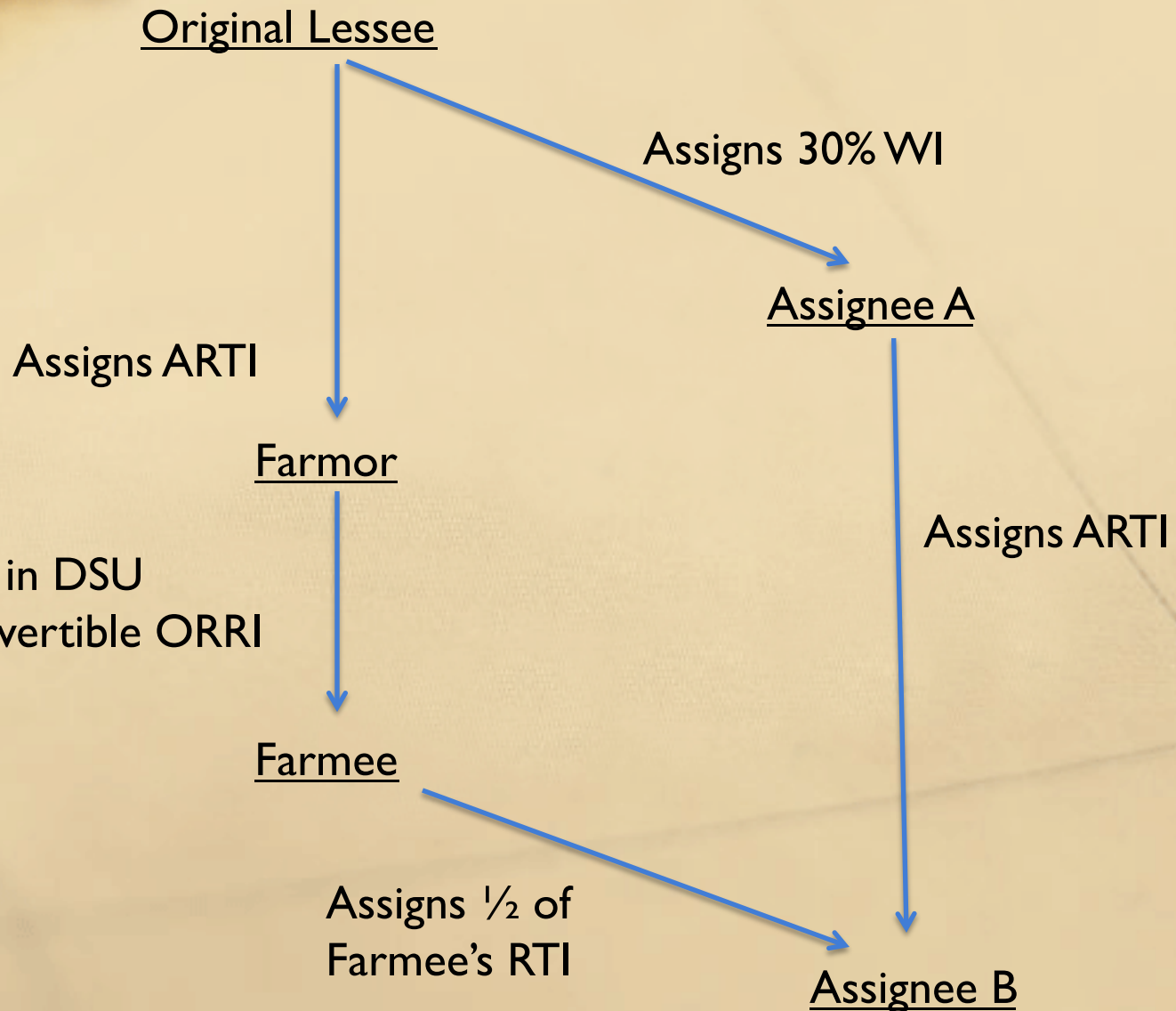
- The Farmout Scenario:
 - Farmor Owns 70% WI at Time of Farmout
 - 70% WI Assigned in DSU Before Payout
 - Proportionately Reduced 5% Override Reserved,
Convertible to $\frac{1}{2}$ of Assigned WI After Payout



Example 2: The BPO Ownership Picture

Owner	% Interest	Interest Type
Landowner	12.5%	Landowner Royalty
Assignee B	65%	Working Interest
	55.125%	Net Revenue
Farmor	3.5% (5% x 70%WI)	Override
Farmee	35%	Working Interest
	28.875%	Net Revenue Interest

Title Chain for Example 2



ARTI = All Right, Title, & Interest

Example 2: Determining Who to Reduce APO

- The Farmor Backs in to $\frac{1}{2}$ of the Interest Assigned
 - Can't Simply Reduce Farmee's Interest
 - Track Farmed Out WI Through the Chain
 - Helpful to Think In Terms of Ratios:
 - 30/65ths of Assignee B's WI not subject to reduction
 - 35/65ths of Assignee B's WI will be reduced by $\frac{1}{2}$ APO
 - Reducing Assignee B's total WI by $\frac{1}{2}$ will not reach the right result



Example 2: The APO Ownership Calculation

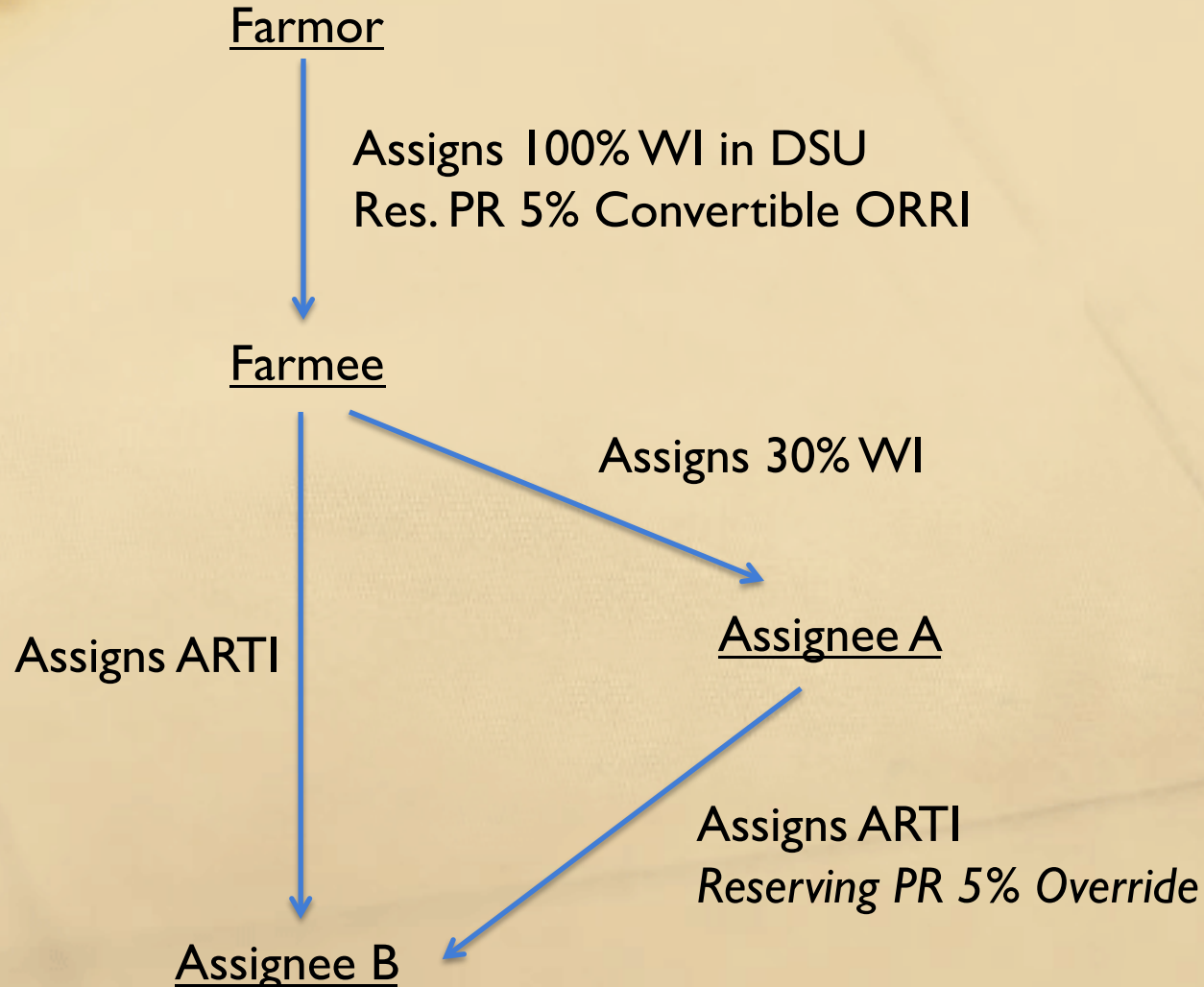
Owner	% Interest	Interest Type
Landowner	12.5%	Landowner Royalty
Assignee B	47.5%	Working Interest
	41.5625%	Net Revenue
Farmor	35%	Working Interest
	30.625%	Net Revenue Interest
Farmee	17.5%	Working Interest
	15.3125%	Net Revenue Interest

Example 3: APO Reduction of Non-Convertible Overrides

- The Farmout Scenario:
 - Farmor Owns 100% WI at Time of Farmout
 - 100% WI Assigned in DSU Before Payout
 - Proportionately Reduced 5% Override Reserved, Convertible to $\frac{1}{2}$ of Assigned WI After Payout



Title Chain for Example 3



Example 3: Look for Ancillary Impacts From Conversion

- Conversion Can Affect More Than Just the Farmed-Out WI and Convertible Override
 - Here, Assignee A Had a Proportionately Reduced 5% Override ($5\% \times 30\% \text{ WI} = 1.5\%$)
 - Upon Conversion, The Proportionate Reduction Factor (the 30%WI) in Cut in Half
 - APO, Assignee A's Reduced Because the WI From Which it Derived is Burdened by the Convertible Override ($5\% \times 15\% \text{ WI} = 0.75\%$)



Troubles with Non-Recording

- Recording statutes generally provide protection to purchaser without notice
- “Shelter Rule” provides protection to those purchasing from a protected purchaser
- In a quiet title action, burden is on plaintiff to show good title (may include actual notice)
- Can a non-record party to a farmout successfully assert rights years later?



2 Main Takeaways

- Get ahead of the curve; develop in advance of payout a cohesive interpretation of:
 - Impact of conversion elections (Single well? Lease?)
 - Notification obligations (who, when, how)
 - Permissible payout cost & recoupment calculations
- Know the chain of title; don't make assumptions about origins of interests



Questions & Comments?

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