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Farmout Agreements and Related Issues

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1 Introduction

The genesis of this paper was John Reeves's and Matthew Thompson's well-received paper from the 49th Annual Institute, *Significant Cases Governing the Onshore Operating Agreement,*[2] I which sought to collect cases that have interpreted the language of the model form operating agreements. The suggestion of the program chairs was that I might do a similar analysis of farmout agreements.

Ultimately, however, I determined that a collection of cases prepared in the same way as the Reeves and Thompson article was not feasible. First, I have already written extensively about farmout agreements and I did not want to repeat myself. Second, and more important, there are no model form farmout agreements. While farmout agreements tend to share common structures, they do not use standard language. Therefore, farmout agreements do not lend themselves easily to the same kind of structured, clause-by-clause analysis that can be done on operating agreements.

Farmout agreements do present, however, frequent and recurring drafting problems. Some of those I have discussed in earlier papers.[3] But cases decided since my earlier work throw new light on those problems, as well as illustrate some that I did not discuss. These cases and the problems they illustrate will be the focus of this paper.

This compilation is subject to several limitations. First, the initial research was done in October, 1998, so later-reported cases may not be included. Second, in the interest of brevity I have discarded cases that I did not think interesting; I recognize, however, that one person's poison is another's sustenance. Third, I have addressed only those cases that arose in the context of farmout agreements, though similar issues are

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2 49th Oil and Gas Inst. 2-1 (Matthew Bender 1998).

3 "Analyzing Oil and Gas Farmout Agreements," 41 SOUTHWESTERN L. J. 759 (1987); reprinted at 25 PUB. LAND & RES. DIG. 5 (1988) (hereinafter referred to as "SMU"); "The Meaning of 'Payout' in Oil and Gas Farmout Agreements," 10th EASTERN MIN. L. INST. 13-1 (Matthew Bender 1989).

often presented by other contracts.[4] Fourth, it is inevitable that I will omit[5] or misstates a case that someone thinks is important. Finally, since this paper is case-oriented, it is not necessarily cohesive. For those looking for a quick overview of developments in farmout agreement litigation over the past decade, however, I offer this analysis as a place to begin.

II. Contract Formation and Interpretation

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.[6] 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."

Farmout disputes are common. Parties often negotiate farmout agreements orally or through an exchange of letters. Indeed, farmout agreements are often entered into in the form of and referred to as "letter agreements.[7] Disagreements often arise over whether the parties have formed a binding contract.[8] And, even when the parties agree that there is a contract, they often disagree about the terms of the agreement.

[1] The Statute of Frauds

The statute of frauds is a potent barrier to claims that a contract has been formed or that it means something other than what it says.[9] Several

4 Nonetheless, I started with more than 200 cases, and I reviewed well over 300 in the course of writing this paper.

5 It is very easy to overlook conditional-assignment or term-assignment farmouts in legal research, because those instruments and the disputes that arise from them may not even use the term "farmout." See, e.g., Riley v. Merriweather, 780 S.W.2d 919, 111 O&GR 336 (Tex. App. -El Paso 1989, writ denied), discussed infra part .03[2].

6 EUGENE O. KUNTZ, JOHN S. LOWE, OWEN L. ANDERSON, ERNEST E. SMITH, & DAVID E. PIERCE, CASES AND MATERIALS ON OIL AND GAS LAW 596 (3d ed.1998).

7 See, e.g., Petrocana, Inc. v. Margo, Inc., 577 So.2d 274,276, 115 O&GR 84 (La. App.--3d Cir. 1991). Agreements other than farmouts may also be called "letter agreements," however. See, e.g., Raydon Exploration, Inc. v. Ladd, 902 F.2d 1496, 109 O&GR 70 (10th Cir. 1990) (discussing a dispute involving a "farmout agreement" and a "letter agreement") and Billingsley v. Bach Energy Corporation, 588 So.2d 786, 118 O&GR 70 (La.App.--2d Cir. 1991) ("letter agreement" used to describe an agreement to pay a finders fee).

8 *See* SMU, *supra* n.3, at 782-783. See generally E. Dale Trower, "Enforceability of Letters of Intent and Other Preliminary Agreements," 24 ROCKY MTN .MIN. L. INST. 347 (1978) (discussing whether parties have formed binding contract or have merely engaged in preliminary negotiations).

9 As I have discussed in SMU, supra n. 3, at 785, most states classify farmout agreements as interests in land, subject to the statute of frauds, whether the interest created by an oil and gas lease is viewed as an estate in land or as a profit a prendre and

cases from several jurisdictions in the last ten years have turned on the statute's requirement of a writing.[10] In *Petrocana Inc.* v. *Margo, Inc.,*[11] the court relied upon the statute of frauds to bar parol evidence of a verbal agreement to extend the time for exercise of an area of mutual interest provision in a farmout agreement.[12] In *Keesun Partners* v. *Ferdig Oil Company, Inc.,* [13] the Montana Supreme Court upheld a summary judgment based upon the statute rejecting a claim that Ferdig had farmed out to Keesun in reliance upon oral representations that Keesun would enter into a long-term gas processing contract with Ferdig.[14] Similarly, in *B & A Pipeline Co.* v. *Dorney,*[15] the Fifth Circuit held that a farmor had not partially performed an allegedly oral gas contract so as to avoid the statute, where the farmor had chosen to market his gas through the farmee but retained the right to take production in kind.[16] In *Crowder* v. *Tri-C Resources, Inc.,*[17] the statute barred enforcement of a supplemental area of mutual interest agreement to farmed-out acreage.17[18] The supplemental agreement was referred to in a letter signed by the party to be charged with its burden and an outline of the affected land was drawn on a plat, but the party to be charged did not sign the plat and the plat did not refer to the letter, and the letter neither referred to the plat nor described the land.[19] In *Texaco Inc.* v. *Mercury Exploration Co.,* [20] the Eighth Circuit Court of Appeals applied North Dakota law to conclude that the time for performance of a written farmout agreement had been not been extended orally.[21] Although the farmout agreement specifically

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whether the form of the contract is bilateral unilateral contract.

10 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. 8 Stat. 405. § 4.24 Car. 2. Ch. 3 § 4; Lynch v. Davis. 181 Conn. 434,435 A.2d 977,980 (1980).

11 577 So.2d 274 (La.App.--3rd Cir. 1991). 11*Id.* at 278. 12816P.2d417(Mont.1991).

12 Id. At 278.

13 816 P. 2d 417 (Mont. 1991)

14 The trial court had held that "there is nothing before the Court that would take the contract between the parties, if there were one, out of the statue of frauds." Id. At 420. The Supreme Court did not reach the statute of frauds issue, because it found that the parties had not reached mutual assent on all essential terms of the contract. Id. At 422-423.

15 904 F.2d 996, 112 O&GR 103 (5th Cir. 1990).

16 904 F.2d at 999-1000.

17 821 S,W,2d, 393, 118 O&GR 538 (Tex. App. – Houston [1st Dist.] 1991).

18 821 S.W.2d at 396-397.

19 Id.

20 994 F.2d. 463, 124 O&GR 70 (8th Cir. 1993).

21 Texaco and Mercury entered into a farmout agreement under which Mercury was to drill three wells before December 31, 1990. 994 F.2d at 464. Mercury failed to complete the wells before the deadline, and refused to pay the $150,000 in liquidated damages

provided that modifications were to be in writing, North Dakota statutory law permits waiver of a writing requirement and oral modification where "the party performing has incurred a detriment which he was not obligated by the original contract to incur.[22] The court refused to apply the doctrine because Mercury gave up no legal rights, incurred no detriment, and did not change its position.[23] It also found no evidence that Texaco should be equitably estopped to assert the writing requirement. [24]

Authority of an agent is another aspect of the statute of frauds.[25] In *In re Manville Forest Products Corporation,*[26] the court applied the statute's requirement that a corporate employee have express, written authority to bind the corporation in transactions involving real property [27] to find a written farmout agreement not binding. [28] The court also refused to apply the apparent authority doctrine,[29] finding that the doctrine does not extend to real estate transactions.[30]

What each of these cases underscores is that fundamentals count. While a contract may be informal and concise, a "lawyered" agreement is more likely to be enforceable and to avoid dispute. These cases illustrate the importance of putting agreements in writing with clear drafting (and the clear thinking that is the prerequisite to clear drafting). That is what lawyers are paid to do.[31]

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provided by the agreement. Id. At 465. Mercury asserted as a defense that Texaco had orally agreed to an extension of time for performance. The federal district court granted Texaco summary judgment. The Eight Circuit Court of Appeals affirmed, explored in its opinion the doctrine of the "executed oral agreement."

22 Id. At 465, citing N.D. Cent. Code § 9-09-06 (1987).

23 Id.

24 Id. At 466.

25 See the discussion at SMU, supra n. 3, at 785. See also Tex. Bus. & Com. Code Ann § 26.01 (West 1998).

26 89 B.R. 358 (U.S.B.C., S.D. N.Y. 1988), applying Louisiana law.

27 La. Civ.Code.Ann. Art. 2996,2997.

28 89 RR. at 365. The employee had written and recorded authority to deal with up to 1000 acres, but the farmout in question covered 3360 acres. *Id.*

29 Apparent authority is "[S]uch authority as a principle 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).

30 89 RR. at 366-368.

31 *See* SMU, *supra* n. 3, at 783-784. See also the discussion at John S. Lowe, "Developments in Nonregulatory Oil and Gas Law: Are We Moving Toward a Kinder and Gentler Law of Contracts?," 42nd OIL & GAS INST. §1.02[a] (Matthew Bender 1991).

[2] The Role of Equity in Farmout Agreements

In limited circumstances, equity may offer protection to the parties to a farmout-based dispute. The number and diversity of the cases that my survey turned up surprised me, though in retrospect it should not have. The informality with which farmout agreements are often approached by industry parties guarantees that claims for equity will be made frequently and occasionally granted. [32]

Equity may offer limited protection to one who fails to make a binding agreement. In *Vortt Exploration Co., Inc. v. Chevron U.S.A., Inc.,*[33] the Texas Supreme Court granted *quantum meruit* relief to a would-be farmee who provided seismic information in the course of unsuccessful negotiations. Vortt proposed that Chevron farm out interests to him, but Chevron refused. Vortt then proposed an operating agreement.[34] Chevron indicated that it might be interested, and negotiations extended over four years, during which Vortt gave Chevron confidential seismic services, graphics, and maps to explain his theory of the property. Instead of finalizing an operating agreement with Vortt, however, Chevron drilled its own well at the location identified by Vortt, and then sued Vortt claiming that his leases were invalid. Vortt counterclaimed seeking quantum meruit. The court of appeals reversed an award for Vortt because the jury had made no finding that Vortt furnished the information to Chevron so as to "reasonably notify Chevron that Vortt expected to be paid for the services and assistance provided."[35] The Texas Supreme Court reversed, reasoning that "the expected payment does not have to be monetary .... Chevron knew that Vortt furnished the information with the expectation that a joint operating agreement would be reached. The parties had negotiated for over four years trying to achieve that end.[36]

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32 My original expectation may have arisen from the fact that I think of — and frequently describe to my students — a farmout agreement as being a lease of a lease. An oil and gas lease transfers mineral rights from the mineral owner to someone in the oil business. A farmout agreement is an additional transfer of those rights, usually with additional conditions or restrictions. Equity is not an important consideration in oil and gas lease interpretation — at least when it is invoked by a lessee — probably because most courts perceive lessees as having knowledge and drafting skills that are superior to those of lessors. The perception of inequality that may make courts reticent to exercise their equity powers in lease disputes is not present in farmout quarrels.

33 787 S.W.2d 942, 108 O&GR 126 (1990). Professor Kramer commented on this case at 108

O&GR 132.

34 787 S.W.2d at 943-944.

35 *Id.* at 944.

36 *Id.* at 945. Vortt is subject to a sarcastic dissent by Justice Hecht:

"Chevron's representatives never asked to see the information. Vortt's representative never told Chevron that Vortt expected anything in return ....

Equity may also provide relief for one who enters into a burdensome contract. For example, in *Uptegraft* v. *Dome Petroleum Corp,*[37] equity permitted a farmor to rescind a farmout agreement. Dome Petroleum farmed out to Atlas and Atlas drilled wells. Both Dome and Atlas knew when they contracted that the Uptegrafts held a 2% leasehold interest in the property.[38] After Atlas had obtained production from two wells, Dome contacted the Uptegrafts and obtained their ratification of the farmout agreement. Dome did not inform the Uptegrafts that there was already production on the tract. In fact, Dome's letter to the Uptegraft indicated that the advantages of the farmout agreement to Dome and its cotenants were "evaluation of production in those units Atlas drills, and protection of leases which would have expired before we could have drilled in this area.[39]The Oklahoma Supreme Court based its decision upholding rescission of the farmout and assignments on the constructive fraud of Dome, as cotenant of the Uptegrafts:

> co-tenants of an estate in land stand in a relation to each other of trust and confidence and neither will be permitted to act in hostility to the other in reference to the joint estate. [citations omitted] Under such circumstances it is not improper to conclude that once the co-tenant decided to communicate with his co-tenant recommending the execution of the farmout he was duty bound to convey the whole truth.[40]

Or, equity may reinstate rights that have failed. In *Hayes* v. *E.T.S. Enterprises, Inc.,* [41] Pogo farmed out to E.T.S. While E.T.S. was drilling, Pogo released the farmed-out lease. The court held that the evidence established that the release was the result of a mistake, and that when there is an execution of a release, rather than a negotiated contract, a party may claim mistake to revoke the release unless another party, in good faith, has relied on the release to its detriment.[42] To similar effect is

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> [A]bsolutely the only thing Vortt expected to gain was favorable consideration of the proposed agreement. ... The information cost Vortt roughly $18,000. The trial court ordered Chevron to pay Vortt $178,500 for it.
>
> Was ever fainter hope more richly rewarded? For not refusing to look at Vortt's information, Chevron must pay ten times its cost. The Court's ruling today should be a tremendous encouragement to benefaction. A frustrated negotiator should never overlook this tactic in attempting to induce agreement. The recipient of such charity, however, should beware." *Id.* at 945-946.

37 764 P.2d 1350, 102 O&GR 557 (Okla. 1988).

38 764 P.2d at 1352.

39 Id.

40 Id. At 1353.

41 809 S.W.2d 652, 119 O&GR 121 (Tex. App. -Amarillo 1991, writ denied).

42 Hayes, the lessor, claimed (1) that Pogo did not make a mistake when executing the release because its execution was intentional and negligent, and (2) that even if Pogo's execution was the result of a mistake, the unilateral mistake did not meet the

Exxon Corp. v. *Gann.*[43] Gann purchased all of Exxon's interest in a single well in Oklahoma, but a mistake in the assignment and bill of sale resulted in the transfer of two additional wells.[44] Exxon sought reformation based on the doctrine of mutual mistake. Gann contended that there was no mutual mistake and that the mistake was the result of Exxon's own negligence.[45] Both the district court and the 10th Circuit held that Gann intended to buy only the one well.[46] The 10th Circuit court refused to overturn the district court's finding of fact, and also recognized that Oklahoma courts have been reluctant to strictly construe the requirement that the part seeking reformation must not have been negligent in forming the contract. Oklahoma courts use a balancing test to determine if the negligence involved rises to a level of "culpable negligence" that violates a legal duty in order to bar reformation.[47]

Equity may even protect one who has technically breached a contract. In *Crescent Drilling & Development, Inc. v. Sealexco, Inc.*,[48] the court upheld a trial court's application of estoppel and waiver to award an investor an interest in a well drilled under a farmout agreement, though the investor had failed to provide funds timely.[49] The facts

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requirements of "remedial mistake." 809 S.W.2d 654. The court of appeals first found that Pogo's release was the result of a mistake because the summary judgment evidence showed that the Pogo official executing the release would not have executed the release had he known of Pogo's farmout agreement with E.T.S. There was also evidence that the official's execution of the release was due to a clerical error. *Id.* at 655. The court also found that E.T.S.'s evidence in the form of deposition testimony of Pogo's officials and employees satisfied the stricter summary judgment standard that applied to an "interested witness"; If a witness is characterized as "interested," as E.T.S.'s witnesses were, then the evidence must be "clear, positive and direct, otherwise credible and free from contradictions and inconsistencies, and could have been readily controverted." *Id.* at 656. The court rejected Hayes's claim that the requirements of the "remedial mistake" rule must have been met for the court to rescind the release. The "remedial mistake" rule would deny equitable relief unless: (1) the mistake is such that enforcement of the contract would be unconscionable, (2) the mistake relates to a material feature of the contract, (3) the mistake occurred despite ordinary care, and (4) the parties can be easily placed back into the status quo before the contract. The court reasoned that the "remedial mistake" rule relates only to negotiated contracts and not to the unilateral execution of a release. The court's rationale was that rescission of a negotiated contract would be inequitable unless the numbered requirements existed. However, when there is a unilateral release rather than a negotiated contract, a party only needs to show (1) that the release was made as a result of a mistake and (2) that another party in good faith did not rely on the release to its detriment. *Id.* at 658-659.

43 21 F.3d 1002, 128 Oil & Gas Rep. 532 (10th Cir. 1994). Professor Maxwell commented on the case at Discussion Notes, 128 O&GR 542.

44 21 F.3d at 1004.

45 *Id.* at 1005.

46 *Id.* at 1005-1006.

47 *Id.* at 1006-1007.

48 570 So.2d 151, 113 O&GR 82 (La. App. -3rd Cir. 1990).

49 570 So.2d at 155.

showed that the company that held the interest had allowed participants to make elections and payments late as a matter of course, had in fact accepted and used the late payment, and owed the investor amounts substantially in excess of the amount due.[50] To the same effect is *Waldron v. Zapata Exploration Company.* [51] There, Waldron farmed out his interests in over 7,500 acres to Zapata Exploration, which promised to pay $1.3 million and commence drilling by a certain date. [52]

Zapata failed to drill by the critical date and an extension, but instead of suing,[53] Waldron encouraged Zapata to continue searching for someone who would drill. Two years later the well was finally drilled and resulted in a dry hole. Waldron then sued Zapata for breach of the original farmout agreement.[54] The appeals court found that the trial court properly submitted the issue of waiver to the jury, which found that the plaintiff had waived any claim against Zapata for breach of the promise to drill by the expiration date of the Cockrell farmout agreement.[55]

Equity may also impose liability, however. *Dews* v. *Halliburton Industries, Inc.,* [56] held that a farmee, who had assigned his interest under the farmout agreement to another who then partially performed by drilling the earning well, would be unjustly enriched if he were permitted to claim the benefit of the well drilled by the assignee without being obligated to pay the charges of the drilling and service companies to which the assignee had defaulted. [57]

[3] Contract Interpretation

Though equity clearly has a role, particularly in contract-formation disputes, the prevailing theme of farmouts cases is that the parties to a transaction will be restricted to and bound by the explicit terms of their agreement. Equitable principles generally will not apply to create obligations that the contract does not address or vary those that it does.

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50 Id.

51 878 S.W.2d 349, 129 O&GR 565 (Tex. App. -Houston [1st District] 1994).

52 878 S.W.2d at 350.

53 Apparently the suit was for the cash payment. In Texas and several other states, however, one cannot recover damages for another's failure to drill without showing that the well that was not drilled would have been profitable. *See* Guardian Trust v. Brothers, 59 S.W.2d 343, 345 (Tex. Civ. App. --Eastland 1933, writ ref'd). *See also* the discussion at SMU, *supra* n. 3, at 812-814.

54 878 S.W.2d at 350.

55 *Id.* at 351.

56 708 S.W.2d 67,89 O&GR 455 (Ark. 1986).

57 708 S.W.2d at 69.

Phillips Oil Co. v. *OKC Corp.*,[58] is an example. Aminoil owned working interests in an offshore lease. When the lease operator proposed a platform, Aminoil decided to farm out its interest to OKC. Aminoil and OKC discussed Aminoil retaining an overriding royalty that would be convertible upon payout of the platform into a net profits interest in the production from the platform. Aminoil and OKC even exchanged written communication to that effect. But when Aminoil drew up the farmout agreement, it contained a reservation of interest in the entire lease. [59] OKC reviewed the agreement for nearly five weeks and then executed it. The trial court found that the lease was unambiguous and that Aminoil had reserved an interest in the entire lease. OKC argued for reformation under Louisiana law based on mutual mistake of the parties. The Fifth Circuit Court held that OKC could not show mutual mistake because the parties were experienced in transactions of this type,[60] the agreement had been extensively reviewed, the provision was central to the agreement,[61] the writing was clear and unambiguous,[62] and there was no evidence that Aminoil shared in the mistake.[63]

A United States District Court in Kansas applied a similar analysis in *Amoco Production Co. v. Hugoton Energy Corp.*, [64] a dispute that arose either because the parties did not understand their complex agreement or because they did not administer it carefully. Amoco farmed out to Hugoton ten drilling blocks, each of which included Amoco's leases in nine sections. [65] The contract provided for Hugoton to earn assignments of Amoco's leases based on a complex scheme of Exploratory Test Wells (ETWs) and Development Test Wells (DTWs),

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58 812 F.2d 265,98 O&GR 84 (5th Cir. 1987). Professor Martin commented on this case in Discussion Notes, 98 O&GR 93.

59 The farmout provided for an overriding royalty of 1/12 of 1/4 of8/8ths of production until net profits were received. The overriding royalty converted into an escalating net profits interest. The net profits interest was specified to be 20% of the one quarter interest until recovery of the first 4,000,000 barrels and 33% thereafter. 812 S.W.2d at 267, n.3. The agreement stated that the overriding royalty and escalating net profits interest applied to "the lease." *Id.* at268, n. 4.

60 *Id.* at 276.

61 *Id.* at 277. The court stated that the provision "goes to a significant purpose behind the transaction."

62 Id. at 276. The court held that the agreement was "drafted in clear and simple terms, such that even a reader with no expertise in oil and gas transactions could find it comprehensible."

63 *Id.* at 278. The court found that" the evidence clearly indicates a deliberate decision on the part of Aminoil, mid-way through the drafting process, to reserve an overriding royalty interest in production from the subject lease as distinguished from an interest in production from Platform A."

64 11 F. Supp.2d 1270, _ O&GR _ (D. Kan. 1998).

65 11 F. Supp.2d at 1272.

and for Amoco to retain a 5.5 percent overriding royalty in ETWs and 7.5 percent overriding royalty and 20 percent back-in in DTWs.[66] Hugoton drilled successful gas wells and received appropriate assignments, which triggered a "drilling clock" that limited Hugoton's right to continue drilling.[67] Hugoton also drilled additional development wells on the assigned acreage, which did not meet the contract definition of DTW, but the parties believed at the time that the wells so qualified and treated them as DTWs.[68] Had the wells qualified as DTWs, Amoco would have been entitled to a convertible 7.5 percent overriding royalty. If they did not, Amoco retained only a nonconvertible 5.5 percent overriding royalty.[69] Amoco contended that the subsequent conduct of the parties implied an agreement to characterize the two wells as DTWs.[70] The court, however, could not find the necessary intent to modify the contract, because the parties were unaware that the contract needed to be modified.[71] Subsequent conduct would have been helpful to interpret an ambiguous clause in the contract, the court said, but neither of the parties asserted that the contract was ambiguous.[72] Finally, Amoco argued that the contract drilling clock had expired, if the two wells were not DTWs, resulting in termination of Hugoton's right to drill additional wells.[73] The court found that Amoco's claim amounted to an action for trespass, which miscarried because Amoco had consented to the wells.[74] and Amoco failed there due to the court's finding of consent. Amoco in turn urged that its consent was negated by mistake, but the court applied the Restatement rule that consent is negated only if the trespasser was aware that the consenter was mistaken; since both Amoco and Hugoton believed the wells to be DTW's, Amoco's consent stood.[75]

Puckett v. Oelze,[76] also reflects a strict-constructionist approach. Puckett farmed out a lease covering one-quarter mineral interest in fifty acres to Oelze with the agreement that Oelze would drill a test well on a

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66 *Id.* at 1272-1274.

67 *Id.* at 1274-1275. The court described the drilling clock as a "use-it-or-lose-it provision. *Id.* at 1274. It appears that the provision was what I termed in SMU, *supra* n. 3, at 775, a "continuous restricted option" designed to avoid or minimize Rev. Rule 77-176.

68 *Id.* at 1275.

69 Id.

70 *Id.* at 1278.

71 *Id.*

72 *Id.* at 1279.

73 *Id.*

74 *Id.* at 1279-1280.

75 *Id.* at 1280.

76 481 N.E.2d 867,87 O&GR 288 (Ill. App. 1985). Professor Kramer prepared a Discussion Note at 87 O&GR 297.

particular ten acres. The farmout also specified that Puckett would assign one half of his interest in the lease to Oelze if the well was not a dry hole and Puckett would receive one eighth of the working interest in the well and the spacing unit on which the well was located. Oelze pooled the farmed-out ten acres with ten acres from another well and drilled a successful well. Oelze maintained that Puckett was entitled only to one half of one eighth working interest, since the spacing unit was 20 acres, only 10 of which was from Puckett's lease.[77] The court held that the farmout agreement was clear on its face, however, and awarded Puckett a one eighth working interest in the well and the 20 acre spacing unit. The Illinois court stated that "where the terms of the contract are plain and unambiguous, the intent of the parties must be ascertained solely from the words of the contract.[78]

In *Pasternak v. Lear Petroleum Exploration, Inc.,*[79] the court rejected a claim of mutual mistake in upholding a summary judgment enforcing the right of parties to an operating agreement to an interest in a well drilled pursuant to a farmout agreement. [80] The farmout agreement specifically provided that it was subject to the operating agreement, but the farmee contended that the provision was included by mutual mistake and asserted in support of its contention that none of its employees had read the final version of the farmout agreement.[81] The court applied an Oklahoma statute[82] limiting reformation for mistake to "mistakes not caused by the neglect of a legal duty on the part of the person making the mistake," concluding that "the mistake alleged ... was caused solely by the failure of [the farmee's] representatives to read the farmout agreement.[83]

The terms of the farmout agreement may be important in determining whether equitable compensation may be available. In *Petrocana, Inc.* v. *Margo, Inc.,*[84] the farmor sought reimbursement for the fair market value of geological data that it had furnished the farmee,

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77 Puckett owned 1/4 working interest in one half of the drilling unit acreage. A "typical" farmout arrangement is that the farmor contributes the lease, the farmee drills the well, and the farmor and the farmee share the working interest equally after payout. See SMU, supra n. 3, at 763. By this logic, one would have expected that Puckett would have been entitled to 1/16 of the working interest in the well. *See* SMU, *supra* n. 3, at 765-768.

78 481 N.E.2d at 871.

79 790 F.2d 828,89 O&GR 160 (10th Cir. 1986).

80 790 F.2d at 834.

81 *Id.* at 834-835.

82 Okla. Stat. Tit. 15, § 63 (1981).

83 *Id.* at 825.

84 577 So.2d 274,276, 115 O&GR 84 (La. App. -3d Cir. 1991).

which had failed to drill.[85] The court rejected the claim noting that it was "an attempt to state a cause of action to recover damages for defendants' non-performance of the [option] farmout agreement" inconsistent with the provision that the "only" penalty for non-performance would be the forfeit of an advance cash payment and the loss of the right to earn an interest in the farmed-out leases.[86]

Generally, however, the strict construction that most courts give farmout agreements arises from the fact that disputes about farmout agreements are "just business." Farmout disputes arise out of complicated and case-specific transactions that the parties choose to structure. Courts have no particular expertise — and no particular interest — in reading between the lines of farmout agreements to find the terms that the parties would have included had they thought their deal through carefully.

III. Common Farmout Issues

While there is no "model" form farmout contract, farmout agreements raise some common issues that cases surveyed address. In this section of the paper, I will address developments relating to these substantive issues.

[1] Key Characteristics of Farmouts

When I wrote in 1987, I discussed at length key characteristics of farmout agreements. — (1) the duty imposed: option or obligation, (2) the earning factor: produce-to-earn or drill-to-earn, (3) the interest earned: divided or undivided, (4) the number of wells: single or multiple-well farmouts, and (5) the form of the agreement: agreement-to-transfer or conditional-assignment.[87] A single dispute, which has occupied an inordinate amount of time of Texas lawyers and Texas courts — resulting in four appellate decisions in seven years — illustrates the importance that all of these factors may assume.

In *Rogers* v. *Ricane Enterprises, Inc.*, [88] commonly referred to as *"Ricane I,"* the Texas Supreme Court considered a Superior Oil Company farmout of part of a lease to Western. One paragraph of the present-assignment farmout agreement conditioned Western's rights upon commencement of drilling operations, while a second paragraph required Western to perform all lease obligations:

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85 577 So.2d at 278.

86 *Id.* Professor Martin questions this reasoning at Discussion Notes, 115 O&GR 99. *See* the discussion of the problems of classifying farmout agreements as "obligation" or "option" agreements at SMU, *supra* n. 3, at 811.

87 *See* SMU, *supra* n. 3, at 792-796.

88 772 S.W.2d 76, 108 O&GR 331 (Tex.1989). Professor Kramer commented on this case in Discussion Notes, 108 O&GR 340.

THIS ASSIGNMENT IS MADE SUBJECT TO THE FOLLOWING CONDITION AND PROVISION:

1.

All of the right, title, interest and privileges herein conveyed to and conferred upon Western will cease and terminate and shall revert to and revest in Superior, unless within thirty (30) days after the date hereof, Western shall commence the actual drilling for oil and gas upon the above described land and at a location thereon which shall satisfy any then existing offset obligation . . . .

2.

Western shall and hereby does assume and agree to perform and discharge all of the [base] lease obligations, express or implied . . . . To this end, it is recognized by the parties hereto . . . that there now are a number of . . . off-set wells which Western shall protect against by the drilling of properly located wells on the above described land, in due and proper time, and subject to all of the applicable provisions of this agreement." [89]

Western's well produced marginally and then was converted to a disposal well, but the lease was continued by production elsewhere on the property.[90] Thereafter, neither the farmee nor anyone acting in its behalf did anything with the property for nearly 23 years until a subsequent assignee of the farmor drilled a prolifically-producing well on the property.[91] The court of appeals interpreted the language of the assignment as incorporating the terms of the underlying oil and gas lease,[92] which required either production or continuing operations to be maintained.[93] Thus, "upon Western's complete cessation of the use of the leased land for the purpose of mineral exploration, development, and production, the determinable fee it acquired by the assignment terminated.[94] The Texas Supreme Court reversed. The Supreme Court

89 772 S.W.2d at 78.

90 *Id.*

91 Rogers v. Ricane Enterprises, Inc., 775 S.W.2d 391,395, 108 O&GR 322 (Tex.App. Amarillo 1987), reversed 772 S.W.2d 76, 108 O&GR 331 (Tex. 1989). In fact, Western's corporate charter was canceled in 1965, and the person charged by the shareholders with the responsibility of settling the affairs of Western, testified that it was his intent to pay the Internal Revenue Service and "get the hell out of Dodge." Rogers v. Ricane Enterprises, Inc., 852 S.W.2d 751, 762, 130 O&GR 392 (Tex.App. -Amarillo 1993), reversed 884 S.W.2d 763, 130 O&GR 415 (Tex. 1994).

92 The appeals court said that "a condition of the assignment was that ... Western assume and perform all obligations, express or implied, required by the underlying Dean lease. The incorporation of the Dean lease into the assignment made the lease a part of the assignment and required their concurrent operation . . . . " 775 S.W.2d at 394.

93 *Id.* at 392.

94 *Id.* at 395.

agreed with the court of appeals that the first paragraph of the assignment made drilling the initial well a condition of earning, which Western had satisfied.[95] The supreme court reasoned, however, that if the farmee breached the agreement, it breached its second paragraph, which was a covenant rather than a condition:

> In paragraph 2 of the assignment, Western simply agreed to perform all the obligations of the base lease, express or implied. Since the parties obviously knew how to create a condition in paragraph 1, the dissimilar language in paragraph 2 indicates that the parties intended the latter paragraph to act as a covenant. We hold that paragraph 2 is a covenant, not a condition, and that the court of appeals erroneously read into paragraph 2 a condition on the estate conveyed.[96]

Thus, if the farmor had a claim it was for damages, rather than for lease termination. The court also reaffirmed Texas law that an oil and gas lease — or a lease assignment — transfers an interest in real property that cannot be abandoned.[97]

On remand, the trial court jury found for the defendants, on reasoning that set up another round of appeals. The jury concluded that the Rogers group, the descendants and assigns of the Western shareholders, had abandoned the purposes for which the assignment was made. [98] The court of appeals upheld the jury's take-nothing award on the basis of an implied special limitation of devotion to purpose articulated in what it described as the "hoary case,[99] of *Texas Co.* v. *Davis.*[100] Again, however, the Texas Supreme Court reversed, this time in a 5-4 decision. In *Rogers* v. *Ricane Enterprises,* Inc., [101] which is referred to as *"Ricane II,"* the Texas Supreme Court stated the doctrine of *Davis* to be:

> *Davis* stands, therefore, for the proposition of law that, if the expressed purpose of the lease is the production of minerals, and the grantee 'entirely and permanently stopped and abandoned the exploration and development' of the property in question, then the estate terminates at once and title reverts to the grantor. [102]

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95 772 S.W.2d at 79.

96 *Id.*

97 *Id.* at 80

98 852 S.W.2d at 759.

99 *Id.* at 756.

100 254 S.W. 304 (Tex. 1923).

101 884 S.W.2d 763, 130 O&GR 415 (Tex. 1994). Professor Kramer commented in Discussion Notes, 130 O&GR 429.

102 *Id.* at 766, citing 254 S.W. at 309.

The court then essentially limited *Davis* to its facts by refusing to imply a drilling purpose in the farmout assignment. Quoting *Ricane I,* the court said that "the language used by the parties [103]... will not be held to impose a special limitation on the grant unless it is clear and precise and so unequivocal that it can be given no other meaning.[104] Further, the court concluded that even were it to imply a drilling purpose in the assignment, the proper remedy for the breach of an implied covenant in a lease is an action for breach of that implied covenant, or a conditional decree of cancellation allowing the parties to fulfill the covenant, and not cancellation of the lease.[105]

The *Ricane* cases are important and interesting. First, the cases are great instructional tools, because the facts underlying *Ricane I* and *Ricane II* illustrate several of the distinctions that I made in my SMU paper. The *Ricane* farmout is a classic illustration of a *drill-to-earn, divided interest, single-well conditional-assignment* farmout agreement. It was a *drill-to-earn, divided-interest* and *single-well* farmout because Western obtained its rights in a separate part of a larger lease by drilling a well, not by completing a well capable of producing in paying quantities.[106] And Western obtained a *conditional assignment* of its interest before it performed, rather than an assignment after it had drilled the earning well. Second, *Ricane I* underscores the distinction between conditions and covenants in farmout agreements. As the Texas Supreme Court held, the farmout agreement made additional operations a promise, rather than a condition of Western's continued ownership. Third, the *Ricane* cases make absolutely clear that a mineral or leasehold interest in Texas is an estate in land that may not be terminated by abandonment, but they leave Texas without a common law doctrine to clear old clouded titles.[107] Finally, *Ricane II* teaches that farmout agreements should contain express provisions to terminate the farmers' earned rights, if the

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[103] *Id.* at 767. The *Davis* lease contained a specific statement that the conveyance was made for "the purpose of drilling, mining, and operating for minerals." 254 S.W. at 305.

[104] 884 S.W.2d at 767, citing 772 S.W.2d at 79.

[105] 884 S.W.2d at 767-768.

[106] Apparently, however, the well Western drilled was capable of producing in paying quantities though it produced only marginally, because it was drilled in 1949 and not converted to a disposal well until 1961. 775 S.W.2d at 392.

[107] The issue of what *ought* to be the law — whether the fee simple determinable estate created by a lease or farmout agreement ought to be subject to an implied limitation of devotion to purpose — excited a great deal of attention. I assisted some members of the Ricane group in preparing their briefs supporting the existence of an implied limitation. Professors Howard Williams and Joseph Shade also filed *amicus curiae* briefs in support of the Ricane group position. Professor Edwin Horner filed an *amicus curiae* brief against it. Approximately two dozen practicing lawyers filed *amicus curiae* briefs, either on behalf of clients or for themselves. After the decision, Professor Bruce Kramer suggested that the problem of how to clear titles should be left to the legislature. See Discussion Notes, 130 O&GR 429, 431-432.

parties intend that they may terminate before the underlying leases end.[108]

[2] The Form of the Agreement: Agreement-to-Transfer or Conditional Assignment

Farmout agreements traditionally have taken the form either of an agreement to transfer 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. Under an agreement-to-transfer form, the farmee obtains its rights only when (and if) it performs the conditions of the contract,108 [109] Under a conditional-assignment farmout, 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.[110]

The farmout's form may have enormous practical significance to the parties' rights and liabilities. Farmors generally prefer an agreement-to-transfer form, because that structure permits a farmor to retain title until the farmee performs. Farmees generally prefer conditional assignments, because they get title immediately.[111]

Recent cases tend to confirm the general preferences of farmors and farmees. Farmors have somewhat more protection against liens with an agreement-to-transfer farmout structure than with a conditional-assignment structure because the farmee has no present right to the property at the time the work is done, which may prevent a lien from attaching. Several of the recent cases involved assertion of mechanics liens and the technicalities of the various states' lien statutes. In *Noble Exploration, Inc.* v. *Nixon Drilling Co., Inc.,* [112] a Texas Court of

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[108] As alternative, the assignment might provide that it is given for "the purpose of drilling, mining, and operating for minerals," to incorporate the implied special limitation of devotion to purpose of Texas Co. v. Davis.

[109] The terminology is not important. What I call an "agreement-to-transfer farmout" is often described as an "agreement-to-convey" form, and what I call a "conditional-assignment" farmout is often called a "term assignment" in the industry. I shall, however, try to be consistent.

[110] *See*, e.g., Vickers v. Peaker, 227 Ark. 587, 300 S.W.2d 29,31-34, 7 O&GR 1177 (1957) (automatic termination) (the subject of comment by Professor Masterson at Discussion Notes, 7 O&GR 1183; Mengden v. Peninsula Prod. Co., 544 S.W.2d 643,647-49,55 O&GR 477 (Tex. 1976) (obligation to reassign). Some writers apparently do not consider conditional assignments to be true farmout agreements. See, e.g., Steven C. Haworth, "Farmouts and Term Assignments -Anatomy 101," Paper 6, 39th Ann. Inst. For Prof. Landmen (Southwestern Lgl. Fnd. 1998).

[111] *See* generally the discussion at SMU, *supra* n. 3, at 796. These practical considerations may be overridden by the tax advantages of the conditional-assignment farmout in situations in which the farmout agreement covers "outside" acreage. See generally SMU, *supra* n. 3, at 773-775.

[112] 794 S.W.2d 589, 114 O&GR 160 (Tex.App. --Austin 1990). The writer commented in Discussion Notes, 114 O&GR 168.

Appeals held that a drilling contractor hired by a farmee under an agreement-to-transfer farmout was not entitled to a mechanics lien against the farmor's leasehold interest in the absence of proof of an express or implied contract between the drilling contractor and the farmor or its agent. [113] *Amoco Production Company* v. *Horwell Energy, Inc.,* [114] reaches that result under Louisiana law.[115] There, the Fifth Circuit Court of Appeals held that a contractor hired by a farmee to drill the earning well in return for an interest in the well was not entitled to a mechanics lien against the farmor's property under Louisiana law because the interest that the drilling contractor was due did not constitute an "amount due" under the lien statute.[116] In *Dews* v. *Halliburton Industries, Inc.,* [117] the Arkansas Supreme Court reversed a trial court's imposition of statutory liens against both the farmor and farmee because of inadequate notice. [118] It also released equitable liens the trial court had imposed upon all the funds held by the production purchaser because "at

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[113] The keys to this decision are (1) the terms of the statute and (2) the court's finding that the farmout agreement was not properly placed in evidence. The Texas lien statute, § 56.001(2), limits liens against mineral properties to those who meet the definition of "mineral contractor," a person who renders services or provide materials "under an express or implied contract with a mineral property owner or with a trustee, agent, or receiver of a mineral property owner." The court reasoned that, because the farmout agreement had not bee introduced at trial, it could not considered in the appeal even though it had been attached to the plaintiffs pleadings. Moreover, the fact that the written farmout agreement existed, precluded a finding of an implied contract. 794 S.W.2d at 592. Texas courts do not appear to have decided squarely whether a farmout agreement establishes the farmee as an agent of the farmor for purposes of the lien statute, and the court's evidentiary ruling avoided that issue in this case. Logic suggests that the validity of liens asserted by contractors against a farmor should be determined by the precise terms of the farmout agreement and the factual circumstances. For example, it would be easier to describe a farmee as the agent of a farmor for lien purposes if the farmout agreement made drilling an obligation of the farmee, rather than an option. In the most common situation, however, where the farmout agreement makes drilling an option of the farmee, the scope of a contractor's lien will probably be limited to whatever interest the farmee earns.

[114] 969 F.2d 146, 120 O&GR 500 (5th Cir. 1992).

[115] Amoco's farmout to Horwell Energy provided that, if the well was completed as a producer, and Horwell complied with certain other terms of the agreement, Amoco would assign Horwell an 80% interest in the well. In turn, Horwell contracted with Gardes Directional Drilling to drill and complete the well. Horwell agreed to assign Gardes part of the interest it was to earn from Amoco. Gardes drilled, but Horwell breached its agreement with Amoco, which elected to terminate the farmout, so Horwell could not perform its promise to assign. Thereafter, Gardes filed a lien against Amoco. 969 F.2d at 147.

[116] *Id.* at 148, citing LSA-R.S. 9:4861(A).

[117] 708 S.W.2d 67,89 O&GR 455 (Ark. 1986).

[118] 708 S.W.2d at 70.

the time the work was performed . . ., [the farmee] did not have an interest in production.[119]

Other recent cases are likely to confirm farmees' preference for the conditional-assignment form of farmout. In *Moncrief* v. *The Louisiana Land & Exploration Co.,* [120] the Wyoming Supreme Court concluded that a farmee had no right to vote the interests covered by an agreement-to-transfer farmout in a consent/nonconsent election under a unit operating agreement. The court reasoned that acreage must be counted as consenting or non-consenting at the expiration of the election period, at which time the farmee did not have a binding agreement.[121] The court rejected the argument that the time at which the farmee had to control the farmor's interest was the spudding of the well and that the doctrine of equitable conversion operated to vest the farmee with the farmor's rights at that moment.[122] In *Beavers v. Kaiser,*[123] however, the North Dakota Supreme Court held that a farmee that had performed its option to drill and complete a well under an agreement-to-assign farmout acquired equitable rights that related back to the date the farmout was given.[124]

A case decided since I wrote in 1987, however, underscores how important it is that the conditional assignment be properly structured. In *Riley v. Merriwether,*[125] lease farmors sought a declaratory judgment that an assigned interest had terminated. The conditional assignment provided that it would terminate either if a new well was not commenced within ninety days after the cessation of the drilling program or if there was no gas production within sixty days after the last well was completed. There was no production from or operations on the property for thirteen months. The assignment did not provide for shut-in royalty payments, though the leases subject to the assignment contained shut-in royalty clauses and shut-in royalties had been tendered to the lessors. A jury found that the assignors had waived their rights to complain. The trial court set aside the jury's finding of waiver and held that the assignee's

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119 *Id.*

120 861 P.2d 516, 127 O&GR 406 (Wyo. 1993). Professor Gereau criticized the case in Discussion Notes, 127 O&GR 433.

121 861 P.2d at 527-528.

122 *Id.* at 525-526. The opinion is lengthy, the facts are complicated, and the reasoning of the court is hazy. The case is the subject of a comment in Owen L. Anderson, "Recent Developments in Nonregulatory Oil and Gas Law," 45 OIL & GAS INST. Ch. 1 (1994).

123 537 N.W.2d 653, 134 0&GR 239 (N.D. 1995).

124 537 N.W.2d at 656-657. The case is the subject of a Discussion Note by Professor Anderson at 134 O&GR 248.

125 780 S.W.2d 919, 111 O&GR 336 (Tex. App. -El Paso 1989, writ denied). The writer commented upon this case at Discussion Notes, 111 O&GR 348, and this text is based upon that comment.

estate had terminated under the terms of the assignment.[126] On appeal, the court rejected the assignees' argument that a clause in the assignment that "reference[d] for all purposes ... the oil and gas leases described in Exhibit A attached hereto and incorporated herein by this reference" incorporated the underlying leases —and their shut-in royalty clauses — in the assignment. The court of appeals concluded that the quoted language merely referenced the exhibit as a description of the leases.[127] Thus, the court of appeals reasoned, the assignment created a fee simple determinable in the assignee that had terminated automatically as a matter of law when production ceased and the grace periods provided in the assignment ran.[128] The assignees could not "bootstrap" the lease shut-in royalty and notice clauses,[129] and waiver did not apply because the assignment had terminated as a matter of law.[130]

The law applied by the court is well-established in Texas, as well as in many other states. The assignment provided for a term for as long as "oil or gas . . . are produced . . . ." It conveyed a fee simple determinable interest that terminated when there was no "production," either actual or constructive. By definition, in Texas, a shut-in well is not "producing," and the assignment contained no shut-in clause or notice-and-demand clause to provide constructive production. If the estate created by the assignment is to be held by constructive production, the assignment must contain a complete set of provisions for constructive production. [131]

[3] Failure of Title

Farmout agreements customarily impose the risk of title failure upon the farmee. [132] Only rarely does a farmout agreement warrant the farmor's title. A recent New Mexico case makes representations nearly the equivalent of warranties, however, in some circumstances. In *Strata Production Co.* v. *Mercury Exploration Co.*, [133] Mercury represented in a farmout agreement, but did not warrant, that it owned or controlled 100%

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126 780 S.W.2d at 921.

127 *Id.* at 924. The court's interpretation of the clause in the corrected assignment that the assignment "reference[d] for all purposes ... the oil and gas leases described in Exhibit A attached hereto and incorporated herein by this reference" is hard to follow, but I believe that it is technically correct. It is a general rule of grammar that a restricting clause qualifies only its nearest antecedent; thus, the phrase "incorporated herein by this reference" modifies "Exhibit A," not "the oil and gas leases described in Exhibit A."

128 *Id.* at 923.

129 *Id.* at 924-925.

130 *Id.* at 923.

131 *See also* Archer County v. Webb, 161 Tex. 210, 338 S.W. 2d 435, 13 O&GR 280 (1960) (commented upon by Professor Maxwell in discussion Notes, 13 O&GR 291) and the commentary at 1 EUGENE O. KUNTZ,THE LAW OF OIL & GAS §15.8 (1987).

132 *See* the discussion at SMU, *supra* n. 3, at 798.

133 916 P.2d 822, 133 O&GR 85 (N.M.1996).

of the working interest in the farmed-out acreage.[134] In fact, Mercury owned less than 100%, and Strata sued Mercury for the value of the difference. Because Strata had paid no independent consideration for the farmout and because Strata had learned of the problem before it commenced performance, Mercury argued that Strata had waived the representation. [135] The New Mexico Supreme Court characterized the farmout agreement as an offer for a unilateral contract running from the farmor to the farmee, to be accepted by commencement of performance, but held that the agreement had become binding by virtue of promissory estoppel even before Strata commenced drilling. Promissory estoppel arose, the court held, from the fact that Strata had drilled the first well on the prospect in reliance upon Mercury's representation, though that well was not located on the farmed-out acreage.[136] The court also rejected Mercury's assertion that it had no liability because it had only agreed to "assign to Strata 100% of Mercury's interest." [137] Because New Mexico has rejected the strict, "four-comers approach to contract interpretation and instead has allowed courts to consider extrinsic evidence concerning the circumstances surrounding the execution of the agreement to determine if contract terms are in fact ambiguous,"[138] the court looked to deposition and trial testimony to conclude that there was substantial evidence that Mercury had in fact promised to assign 100% of the working interest to Strata. [139]

[4] Well "Commencement"

Farmout agreement commencement-of-drilling provisions vary widely.[140] In their dealings with one another, however, people in the oil and gas business are likely to seek more precision than is offered by oil and gas lease language that commonly requires mere "commencement of operations" or "commencement of drilling" — terms that are generally given very liberal interpretation by the Courts.[141] In farmout agreements,

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134 916 P.2d at 825.

135 *Id.* at 826.

136 *Id.* at 828-829. Further, the court held that promissory estoppel applied even though Strata's reliance was not detrimental, since the first well was a very good well. *Id.* at 829.

137 *Id.* at 830.

138 *See id.,* citing C.R. Anthony Co. v. Loretto Mall Partners, 817 P.2d 238,242-43 (N.M. 1991) and Mark V, Inc. v. Mellekas, 845 P.2d 1232, 1235-36 (N.M. 1993).

139 916 P.2d at 831. The court also held that though the farmee had sold most of its interest in the prospect to investors who were not parties to the action, the farmee was entitled to 100% of the damages because the farmout was between Mercury and Strata and there was no privity of contract between the investors and Mercury. *Id.* at 831-832. Further, the court appeared to adopt the "lost royalty" rule as the measure of damages for breach of a drilling contract. *Id.* at 832-833. *See also* the discussion at SMU, *supra* n. 3, at 812-814.

140 *See* the discussion at SMU, *supra* n. 3, at 802-803.

141 *See* generally KUNTZ, LOWE, ET AL., supra n. 6, at 176-180.

the requirement more frequently is that the farmee "commence the actual drilling" of a well or that a well be "spudded." Both terms are commonly understood to be intended to require that a drill bit have pierced the ground.

A recent federal case from Mississippi illustrates how important word variation may be in drafting commencement provisions in farmout agreements. In *Exxon Corporation.* v. *Crosby Mississippi Resources, Ltd.*, [142] an exploration agreement continuous-drilling provision allowed a 180 day gap between completion of an exploratory well and "actual commencement of drilling" of a development well.[143] The Fifth Circuit Court upheld a lower court's ruling that the contract term was ambiguous and that drilling "actually commenced" when a small truck-mounted drilling rig began drilling for the installation of conductor pipe.[144] The court reasoned that "creation of the conductor pipe hole was part and parcel of the actual drilling process, and was more than preparatory activity, such as the gathering of equipment or the clearing of land." [145] *Neomar Resources, Inc.* v. *Amerada Hess Corporation* [146] also teaches a drafting lesson, one particularly important in farmouts of property upon which wells have been drilled previously. There, the court held that a farmee could not maintain a claim against the farmor and its assignee for failing to permit the farmee to use a nonproducing hole drilled to a deeper formation, which caused the farmee to have to spend millions of dollars to drill a twin well. The court noted that the farmout agreement did not give the farmee an express right to use the borehole. [147] It rejected

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142 154 F.3d 202 (5th Cir. 1998).

143 *Id.* at 206, n. 8.

144 *Id.* at 207. Conductor pipe is installed to prevent the borehole from caving in under the weight of the drilling rig. After its installation, the remaining drilling work is performed through the conductor pipe.

145 *Id.* at 208. The court also refers, apparently with approval, to the district court's conclusion that if the parties had meant that only the use of a larger drilling rig would satisfy the "commencement of actual drilling" language, they could have used language to that effect in the contract. *Id.* at 207. Something like "the term 'drilling operations' shall mean actual drilling operations with a drilling rig on location adequate to drill to the permitted depth, together with all attendant equipment, with the drill bit actually turning in the ground, conducted in good faith, with reasonable diligence, and in a good and workmanlike manner" might have sufficed.

146 648 So.2d 1066, 132 O&GR 613 (La. - 1st Cir. 1994).

147 648 So.2d at 1068. While the scope of the implied easement for use of the surface should extend to the use of abandoned well bores on the farmed-out property, this case suggests that the farmout agreement should grant that right expressly if the farmee anticipates re-entering an abandoned well. For discussion of the implied easement, see generally, John S. Lowe, "The Easement of the Mineral Estate for Surface Use: An Analysis of Its Rationale, Status and Prospects," 39th ROCKY MTN. MIN. L. INST. Ch. 4 (1993) and John S. Lowe, "The Lessee's Right to Free Use of Produced Substances: New Wine in Old Bottles," 37 NAT. RES. J. 729 (1997).

the argument that the reasonable prudent operator standard implied the duty, because that duty runs from a lessee to a lessor, not to the lessee's assignee. The court also rejected the argument that the refusal violated public policy against waste and inefficiency, noting that, if such a cause of action existed the right would lie with the state, not the farmee .[148] Finally -and this is the most important drafting point made by the case - the court stated that it did not accept the farmee's argument that a lessee or farmee was always entitled to use improvements on the land.[149]

[5] Objective Depth

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 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.[150]

The meaning of "objective depth" was at issue in *Arleth* v. *Freeport-McMoran Oil & Gas Co.*[151] Freeport drilled a well to the 15,900' sand, allegedly discovered what the court described as the "Mother Lode," but could not complete because of mechanical problems. [152] Subsequently, Freeport agreed with the Arleth group152 [153] to drill an additional well and "in the event that . . . the well . . . is not completed as a commercial producer . . . after reaching the well's objective depth in a straight hole configuration, then . . . [Freeport] shall attempt to sidetrack the well . . . to . . . [the 15,900' sand.]."153 [154] Freeport drilled to within 100 feet of the 15,900' sand, but refused to sidetrack the well because the well was a commercial producer at the shallower depth. Later, Freeport drilled its own offset well to the deeper sand and obtained prolific production.[155] The investors sued, and a federal district court found Freeport liable for more than $9 million for securities fraud, breach of contract, and breach of the implied covenant of good faith and fair dealing.[156] On appeal, Freeport argued that the letter agreement was ambiguous and that its reference to the well's "objective depth" meant

148 648 So.2d at 1068.

149 *Id.* at 1069.

150 For further discussion, *see* SMU, *supra* n. 3, at 805-808.

151 2 F.3d 630, 128 O&GR 62 (5th Cir. 1993), reh'g denied, 9 F.3d 105 (5th Cir. 1993).

152 2 F.3d at 632.

153 *Arleth* is not, strictly speaking, a farmout case. The letter agreement arose out of a corporate merger. *Id.* at 631.

154 *Id.* at 633.

155 *Id.*

156 *Id.* at 632.

the measured depths that would permit production from any of the three formations in which commercial production had been encountered. The Fifth Circuit rejected this argument, holding that the agreement unambiguously obligated Freeport to drill "two alternative configurations" to the 15,900' sand.[157]

Without the full text of the letter agreement, one cannot evaluate the debate that took place in *Arleth* over whether the term "objective depth" was ambiguous. Clearly, however, the language could have been better structured. Clearly, as well, the dispute might have been avoided by well-chosen prefatory statements of purpose.[158]

[6] Nonoperating Interests Reserved

Farmor's usually reserve a non-operating 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.[159] A recurring problem is what duty, if any, the farmee owes to the farmor to protect the non-operating interest. Specific issues include the "washout problem," whether the overriding royalty or production payment owner is protected if the lease upon which the non-operating interest is based is permitted to terminate, after which the property is re-leased by the operating rights owner.

[a] The "Washout" Problem

The "washout" problem arises whether the lease transfer is pursuant to a farmout agreement or a "straight" assignment, though this discussion will be limited to those cases involving farmout agreements.[160] If the transferee permits the lease to terminate and then subsequently re-leases the property, should the original lessee's non-operating interest be recognized under the new lease? Not affording the original lessee such protection tempts assignees to wash out non-operating interests to increase the assignees' profits. But it is basic oil and gas law that an overriding royalty interest is limited in duration to the life of the leasehold interest, because the overriding royalty is carved out of the leasehold interest. By definition, then, termination of the leasehold interest extinguishes the overriding royalty. In addition, there may be sound business reasons for an assignee to permit a lease to terminate and then re-lease the property. In most states, the implied protections against washout are limited to non-existent.[161]

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157 *Id.* at 634.

158 See the discussion at SMU, supra n. 3, at 790.

159 *Id.* at 829-832.

160 The broader issue might well be the subject of a separate paper at one of these institutes.

161 *See* Bruce A. Ney, Note, "Protecting Overriding Royalty Interests in Oil and Gas Leases: Are the Courts Moving to Washout Extension or Renewal Clauses?," 31

In *Matter of GHR Energy Corp.,* [162] the Fifth Circuit applied Texas law to deny protection to an overriding royalty owner. Medallion Oil Company acquired overriding royalty interests in property farmed out by El Paso Natural Gas Company to TransAmerican Natural Gas Corporation, as a finders fee. Subsequently, TransAmerican settled a gas contract take-or-pay judgment against El Paso by terminating all agreements between the companies and accepting an assignment of El Paso's mineral interest.[163] Medallion contended that its overriding royalties were still valid, but the court rejected its claims, relying upon prevailing Texas law [164] and upon language in TransAmerican's assignment to Medallion that specifically allowed TransAmerican to terminate its lease interests at will. [165] The court noted in dicta, however, that "it might well reach a different result if the facts here had suggested that TransAmerican surrendered its interest in the lease to destroy the rights of the overriding royalty interest owner.[166]

Marathon Oil Co. v. *Moye,*[167] applied similar principles to a royalty interest in a Colombian coal license. The licensee assigned the license to Marathon in return for cash and an overriding royalty interest.[168] When the Colombian government nationalized the coal industry, Marathon relinquished the licenses.[169] The royalty owner contended that Marathon owed it a fiduciary obligation to protect its interests. [170] A Texas court of appeals held that no fiduciary duty was created by the license assignment and the reservation of the royalty interest.17o [171]

A federal court upheld an arbitration award that protected a farmor against washout, however, in *In the Matter of the Arbitration Between Asamera Ltd. and Tesoro Petroleum Corp.,*[172] Asamera's predecessor

WASHBURN L.J. 544 (1992).

162 972 F.2d 96 (5th Cir. 1992), rehearing den'd 979 F.2d 40 (5th Cir. 1992), cert. denied, 507 U.S. 1042, 113 S.Ct. 1879, 123 L.Ed.2d 497 (1993). The writer was one of the attorneys for TransAmerican in the appeal to the Fifth Circuit.

163 972 F.2d. at 98.

164 *Id.* at 99.

165 *Id.*

166 *Id.* at 101.

167 893 S.W.2d 585, 130 O&GR 645, (Tex.App. -Dallas 1994). The writer commented on the case in Discussion Notes, 130 O&GR 657.

168 893 S.W.2d at 588. The court describes the interest as a "nonparticipating royalty." In the oil and gas industry, an interest of this kind would ordinarily be called an overriding royalty, even though it was carved out of a contractual license for a term of years, rather than out of an estate in land.

169 *Id.*

170 *Id.* at 592.

171 *Id.*

172 807 F.Supp. 1165 (S.D.N.Y. 1992).

entered into a Technical Assistance Contract with the Indonesian state-owned oil company, Pertamina, in 1968. The TAC was limited to twenty years but contained a statement that a request for extension would be given "sympathetic consideration" by Pertamina. Pursuant to a farmout agreement that stated it would be governed by Texas law, Asamera assigned two areas covered by the TAC to Tesoro and retained an overriding royalty. In 1989, after the 1968 TAC had terminated, Tesoro entered into its own TAC with Pertamina covering the farmout areas, retroactive to the date the 1968 TAC expired. Tesoro then stopped paying Asamera the overriding royalty and Asamera maintained that the royalty continued under the new TAC. In an American Arbitration Association proceeding, the arbitrators agreed with Asamera. [173]

Tesoro argued that since the overriding royalty was carved out of the 1968 TAC, it must terminate when the TAC terminated — that Asamera could acquire "no greater estate" than the 1968 TAC created. [174] The arbitrators, however, reasoned that the TAC was a contract to produce oil and gas, not a lease governed by Texas property law, so that the "no greater estate" principle did not apply.[175] The 1988 TAC was therefore subject to Asamera's overriding royalty even though the farmout of the 1968 TAC did not contain the explicit language that would have been necessary to attain this result under Texas property law. The district court confirmed the arbitration award on the grounds that the arbitrators had not manifestly disregarded Texas law.[176]

[b] Extension and Renewal Provisions

As a result of the uncertainty whether a lessee who transfers operating rights in a lease will by protected against a washout and when such protection will be extended, lease assignments reserving non-operating interests frequently contain *extension and renewal* provisions guaranteeing recognition of the transferor's non-operating interest in lease extensions and renewals.[177] In *GHR Energy Corp.,* the extension

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173 *Id.* at 1166.

174 *Id.* at 1167. The writer testified for Tesoro in the arbitration as an expert on Texas oil and gas law.

175 *Id.* at 1168.

176 *Id.* at 1169.

177 An example of an extension and renewal clause follows:

> This *[reservation, grant, conveyance, etc.]* shall apply as well to all modifications, extensions and renewals of the supporting lease, or any part thereof, by the lessee, his successors and assigns, or any sublessee, his successors and assigns. "Renewals" shall include wholly new leases made by any of these persons within *[30, 60, 90, etc.]* days after the lapse of current lease coverage. The terms of this paragraph shall be contractually operative as a part of all modification, extension and renewal leases as well as the current lease. If subject to the Rule against Perpetuities, this effect shall be treated as wholly lapsed and without effect commencing one day before the maximum interval permitted by the Rule."

and renewal provision simply was not broad enough. It stated that the overriding royalty "shall also apply, extend to and include each and every renewal or extension of *an oil and gas lease* covered by this Assignment which is acquired by [TransAmerican], directly or indirectly, prior to or within one (1) year of the expiration or termination of said oil and gas lease." [178] In the event that led to the dispute, TransAmerican terminated the underlying lease and acquired the mineral estate. Incomplete or imprecise drafting often leads to problems. The root of the problem, of course, is conceptual. If an oil and gas lease is regarded as a conveyance of an interest in real property, as it is in most states, then it is not possible either to extend or renew it. The issue then becomes when a new grant is closely enough related to the initial conveyance that the parties would have regarded it as an "extension or renewal." And that, of course, is usually determined by the language of the clause.

Robinson v. *North American Royalties, Inc.* [179] illustrates another common problem with an extension and renewal clause in the context of a farmout agreement —the problem of privity. Robinson assigned a lease to North American Royalties with a reservation of an overriding royalty. The assignment contained an extension and renewal clause that provided that the overriding royalty would also apply to any future lease acquired by North American, its successors or assigns, that covered any portion of the same property if it was acquired within one year of the expiration of the present lease. [180] North American in turn entered a farmout agreement with Stone Oil Corp. Stone drilled a successful well and North American assigned that portion of the lease containing the producing well, subject to Robinson's overriding royalty. Stone next drilled a dry hole outside of the assigned area and then allowed the remainder of the lease to expire. Soon after the lease expired, Stone entered a new lease with the lessors.[181] Robinson argued that the anti-washout clause applied to the new lease and was therefore subject to his overriding royalty interest. The Louisiana Court of Appeals held that Stone was not contractually

JOHN S. LOWE, 7 WEST'S TEXAS FORMS § 11.11 (3d ed. West 1997). Statutes, as well as the common law or the agreement of the parties, may offer a farmor protection. In Columbia Natural Resources v. Tatum, 58 F.3d 1101, _ O&GR _ (6th Cir. 1995) a United States Court of Appeals held that allegations that the defendants allowed or caused Columbia's farmed-out leases to terminate so that defendants could enter into new oil and gas leases with the lessors constituted a claim that Columbia might pursue under the Racketeering Influenced and Corrupt Organizations Act (RICO).

178 972 F.2d at 99 (emphasis added).

179 463 So.2d 1384, 84 O&GR 281 (La. App. 1985),509 So.2d 679, 95 O&GR 292 (La. 1987). Professor Martin commented on these decisions in Discussion Notes, 84 O&GR 292 and 95 O&GR 304.

180 463 So.2d at 1385.

181 *Id.*

bound under the Mineral Code[182] unless it drilled a successful well and received an assignment. There was privity of contract between Stone and Robinson only for that portion of the lease that Stone was actually assigned.[183]

The root of these problems, of course, is conceptual. If an oil and gas lease is regarded as a conveyance of an interest in real property, as it is in most states, then it is not possible either to extend or renew it. The issue then becomes when a new grant is closely enough related to the initial conveyance that the parties would have regarded it as an "extension or renewal." And that, of course, is usually determined by the language of the clause. Incomplete or imprecise drafting often adds to the difficulties.

[c] Reassignment Clauses

An alternative protection for a nonoperating interest owner is to obligate the transferee to offer to reassign the lease before permitting the lease to terminate. Typically, such a provision is referred to as a *reassignment clause.*[184] Reassignment clauses too may present enforcement problems because of drafting inadequacies.

Eland Energy, Inc. v. *Rowden Oil & Gas, Inc.* [185] illustrates the point, though the drafter was vindicated. In *Eland,* the farmor and the farmee executed a farmout agreement that stipulated that the farmor would assign the farmee 40 acres in the form of a square as nearly as possible around each producing well the farmee completed. The agreement also provided that it was binding on all parties and their heirs, successors and assigns, but not assignable without the farmee's written consent. Subsequently, the farmor assigned the entire property to the farmee, subject to the terms of the original farmout agreement, to avoid the burden of numerous assignments of individual 40 acre tracts. In turn,

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182 The court interprets Article 128 of the Mineral Code as legislatively overruling the sublease/assignment distinction and imposing a statutory privity of contract between a sublessor and a sublessee and the sublessee's assignee. *Id.*

183 *Id.* at 1388.

184 An example of a reassignment clause follows:

> In the event that Assignee should elect to surrender, let expire or terminate, abandon or release any of his rights in said lease acreage, or any part thereof, assignee shall notify Assignor not less than thirty (30) days in advance of such surrender, expiration or termination, abandonment or release and, if requested to do so by Assignor, the Assignee shall immediately reassign such rights in said lease acreage, or such part thereof, to Assignor. 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 that existed at the date of the original assignment.
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> JOHN S. LOWE, 7 WEST'S TEXAS FORMS § 11.12 (3d ed. West 1997).

185 914 S.W.2d 179, _ O&GR _ (Tex. App.--San Antonio 1995). This writer has commented on the case in Discussion Notes, _ O&GR _.

the farmee agreed to continuously develop the lease and to assign back to the farmor any undeveloped portions when all drilling ceased.[186] Several years later, the farmee assigned undivided interests in the lease to his children, specifically "subject to any reservations, limitations or burdens effecting [sic] said leases." [187] Eventually, Eland acquired the interest of one of the farmor's children. Eland claimed an undivided one-third interest both in the forty-acre tracts around producing wells and in the undeveloped acreage of the entire farmout property. The farmor's successors in interest sought specific performance of the reassignment provision. The trial court found that Eland had obtained its interest subject to all of the terms of the farmout, including the reassignment obligation and granted summary judgment for the farmor's successors. [188] On appeal, Eland raised several reasons why summary judgment was improper.

Eland claimed that the reassignment claims were barred by the four-year statute of limitations relating to contracts to convey land. The court of appeals swept all of Eland's objection aside, however. The court concluded that because the assignment of the entire lease to the farmee was made subject to the farmout and the reassignment obligation it contained, the assignment transferred only legal title. The farmee obtained equitable title to lease property only by earning it by drilling wells, and the legal and equitable titles merged when the 40 acre tracts were designated. [189] The suit was therefore a quiet title action not subject to any statute of limitations. [190] Eland additionally contended that the vagueness of the description of the land to be conveyed pursuant to the farmout caused the statute of frauds to bar any obligation to reassign unearned acreage; the phraseology was "40 acres in the form of a square as nearly as possible," and no one knew at the time of the assignment what portions would be reassigned because no one knew where the wells would be located. The appellate court concluded that the farmee's right to designate, coupled with his interest in doing so, satisfied the statute of frauds. Finally, the court noted that some of the owners of the farmee's interest had already designated the tracts. [191]

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186 914 S.W.2d at 182.

187 *Id.* at 183.

188 *Id.* at 184.

189 *Id.* at 185

190 *Id.* at 186.

191 The *Eland* analysis is an example of what has been called the "seller's selection clause exception" to the statute of frauds. James v. NICO Energy Corp., 838 F.2d 1365, 1369, n. 3, 102 O&GR 352 (5th Cir. 1988) (declining to apply the exception to an option "to participate in subsequent wells on an additional 700 acres (approximately) to be designated by NICO from acreage which it presently has under lease" (838 F.2d at 1368, n. 2) as irrelevant to the dispute before it.) *Id.* at 1369, n. 3 (Discussed by the writer in Discussion Notes, 102 O&GR 368). "[T]he statute of frauds is met where the contract,

Ricane II, [192] discussed at III. [1], above, also illustrates the difficulty of structuring language in a reassignment clause that will fit the occasion. There, the farmee corporation did not honor the reassignment clause, and instead went out of business and dissolved. The successors to the farmor argued in vain that the farmee's rights had nonetheless terminated. [193]

Indeed, the biggest problem with reassignment clauses may be that they *will* be enforced in situations in which the lease assignee or farmee do not expect them to be.[194] In *Shore Exploration & Production Corp.* v. *Exxon Corp.,* [195] Shore assigned leases to Exxon, Texaco and Eastern reserving an overriding royalty in separate transactions. The agreements to assign required the assignees to pay delay rentals or to notify Shore of its intention not to pay, so that Shore could request reassignment. [196] Subsequently, Texaco acquired the interests of the other assignees and entered into an agreement with Shore ratifying Shore's overriding royalty and incorporating the terms of the Exxon and Texaco agreements

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instrument or agreement, gives either party the unqualified right or power to make a selection or determination of the details without the necessity of further agreement or approval of the other party." Tiller v. Fields, 301 S.W. 2d 185, 190, 7 O&GR 1513 (Tex. Civ. App.--Texarkana 1957) (commented upon by Professor Masterson in Discussion Notes, 7 O&GR 1521). The tract from which the selection is to be made must be described with reasonable certainty, however. Williams v. Ellison, 493 S.W.2d 734, 737 (Tex. 1973).

192 Rogers v. Ricane Enterprises, Inc., 884 S.W.2d 763, 130 O&GR 415 (Tex. 1994).

193 884 S.W.2d at 765.

194 In "The Reassignment Provision -Meaningful or Not?," 20 ROCKY MTN. MIN. L. INST.601, 623 (1975), Paul W. Eaton, Jr. aptly described the reassignment clause as "a vicious, vengeful dog ready to bite the unwary person who ignores it."

195 976 F.Supp 514, _ O&GR _ (N.D. Tex.1997).

196 The Texaco/Shore reassignment provision provided that;

> Should Texaco elect not to pay delay rentals on lease(s) ... in which Shore has only an overriding royalty interest, Texaco shall first notify any party who owns a working interest in such lease or leases of its intention to surrender said lease or leases by non-payment of delay rentals. If the other working interest owner(s) elect not to pay the delay rental(s), Texaco shall then advise Shore of its intent to release such lease(s) and Shore shall have the right to make such payment(s) and Texaco shall assign its interest in said lease(s) to Shore. Texaco shall give Shore thirty (30) days advance notice of its intention not to make such delay rentals. Shore shall advise Texaco whether it wishes to make said delay rental payments within fifteen (15) days of receipt of notice. Failure to timely respond shall be considered an election by Shore not to make such payment(s). Texaco shall have no liability to Shore for failure to offer any lease(s) to Shore, provided such failure is not the result of gross negligence or willful misconduct. Texaco agrees that it will furnish Shore each month with copies of rental receipts as proof of rental payments being made on lease(s) during the preceding month.
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> 976 F.Supp. at 524.

with Eastern to assign, but not the Eastern assignments.[197] After drilling several dry holes, Texaco assigned the leases, covering over 82,000 acres and subject to Shore's overriding royalty and the reassignment clause, to Eastern. Eastern neither paid the rentals nor gave the notice required by the reassignment clause. All of the leases were forfeited for failure to pay delay rentals.[198] Shore then sued Exxon, Texaco and Eastern for damages. Texaco asked for summary judgment that it was not liable because it no longer owned an interest in the leases when the failure to provide notice occurred. The court found Texaco liable on a theory of privity of contract, for Eastern's failure to give notice regarding the leases Texaco had acquired directly from Shore and the leases assigned by Exxon to Texaco, which had been the subject of the Texaco/Shore ratification.[199] The court granted Texaco's motion, however, with respect to the leases that Texaco had acquired from Eastern and then reassigned to Eastern, finding that an area of mutual interest agreement between Texaco and Shore did not establish contractual privity[200] and that, while the reassignment provision was a covenant running with the land, Texaco was no longer in privity of estate with Shore.[201]

Probably the simplest way for a farmee to avoid liability after assignment of lands subject to a prior reassignment obligation is to provide in the reassignment clause itself that it will be relieved of liability after an assignment.[202] Merely providing that assignments may be made only with the farmor's approval (perhaps with the stipulation that approval would not be unreasonably withheld) does not necessarily relieve the original promisor of liability on the basis of privity of contract. [203] Perhaps because it had foreseen the possibility of a situation such as it confronted, Texaco had included in its reassignment agreement with Shore a provision that "Texaco shall have no liability to Shore for

197 *Id.* at 521.

198 *Id.* at 519-520.

199 *Id.* at 521-522.

200 *Id.* at 522. Shore argued that the AMI clause controlled all subsequent leasehold interests acquired by Texaco in the AMI area, including the Eastern leases when they were assigned to Texaco. The court disagreed, reading the contract provision as not being "intended to apply to every lease into which Shore and Texaco thereafter entered." *Id.*

201 *Id.* at 524.

202 Something like "provided, however, that in the event of assignment of this property in whole or in part, liability for the breach of any obligation hereunder shall rest exclusively upon the owner of this property, or portion hereof, who commits such breach" — a clause found in many oil and gas leases — should suffice.

203 Texaco made a similar argument in the *Shore* case, urging that Shore's consent to Texaco's release of certain leases indicated its agreement to release Texaco from the reassignment obligations relating to the retained leases. The court noted the general rule that an "obligor remains liable for performance of a contractual obligation even after an assignment." 976 F.Supp. at 525.

failure to offer any lease(s) to Shore, provided such failure is not the result of gross negligence or willful misconduct.[204] That limitation did not protect Texaco, however, for the court held that neither Texaco's notices to Shore that the leases were being assigned to Eastern nor Texaco's request that Eastern "handle" the problem of lease default rose to the level of "slight diligence" or "scant care" necessary to avoid gross negligence.[205]

[7] "Payout" Under Farmout Agreements

Farmout agreements almost always provide that the farmee will "carry" the farmor in drilling operations under the agreement —i.e., that the farmee will pay all of the expenses of drilling operations. Tax rules[206] and business realities[207] require that the farmor postpone sharing any operating rights in the farmed-out property with the farmee until after "payout." The period from when the well is drilled and completed until the farmee has recouped its drilling and development costs, as well as its operating costs during that period, is generally called the "payout" period. A typical farmout agreement arrangement gives the farmor a non-operating interest in production —usually an overriding royalty interest —until "payout." After "payout," the farmor's interest may be convertible at the farmor's option, or convert automatically, to a share of the working interest [208]

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204 *Id.* at 524.

205 *Id.* at 525-526.

206 The contributions of property and cash or services by the farmor and farmee are treated as a "sharing arrangement," or a pooling of capital, a tax-free transfer to form a new economic venture, rather than as a sale of property or services. *See* the discussion at SMU, *supra* n. 3, at 765-768.

207 The Fifth Circuit has described a "carried interest" as follows:

> In any carried interest transaction, one of the owners of the working interest in property is willing to advance the funds necessary for drilling of wells and development of production of oil or gas, and to look only to the other owner's share of production for the other owner's contribution to such costs. The party who puts up the money is called the carrying party because he risks his entire investment against the possibility that there will not be enough production to reimburse him for his costs. The other party is called the carried party because he takes no risks. The carried party agrees to wait until the carrying party has recouped his drilling and development costs out of production before he takes any payments on his share. The carried party is not personally liable for any costs and loses nothing if there is no production.
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> *United States v. Cocke*, 399 F.2d 433, 436 (5th Cir. 1968), cert. denied, 394 U.S. 922 (1969).

208 Typical payout provisions effectively permit the farmee to convert its expenditures on behalf of the farmor's interest to a nonrecourse loan recoverable out of the farmor's share of production. RONALD POLEVOI, FEDERAL TAXATION OF OIL AND GAS TRANSACTIONS § 8.05[3][c] (Matthew Bender 1987).

Because "payout" may have great economic importance to both the farmor and the farmee, it is small wonder that the parties often disagree about what the term means in particular circumstances.[209] Several cases turned up in this survey shed light upon payout issues, though not all of them arose directly in the context of a farmout agreement.

As I have observed elsewhere, "what specific costs and revenues are considered in calculating complete payout should be determined by the directness of their relationship to the asset; costs and revenues that can be directly related to the earning well should be considered in calculating payout.[210] The additional cases that I encountered in this survey are generally consistent with that analysis. In *Aminoil USA, Inc.* v. *OKC Corporation,*[211] the court held that interest and legal fees relating to a dispute between the farmor and the farmee over the extent of the farmor's retained ownership interests could not properly be charged in determining "payout" under a farmout agreement. The court observed that the agreement did not provide for interest on the farmee's costs,[212] nor was it permitted by generally accepted accounting principles.[213] The court held also that the farmout agreement's reference to legal costs to be charged to the net profits account did not include costs related to disputes between the parties, such as the one before it.[214] An analogous analysis is provided by *Krafve* v. *O'Keeffe,* [215] where a court applied a common-sense interpretation of a poorly-drafted stock-for-working-interest agreement to hold that "payout" was to be determined by taking into account only costs incurred in producing revenue from the two mineral properties farmed out, rather than all general expenses of the operator.[216] In addition, in *Burg* v. *Ruby Drilling Company, Inc.,* [217] the Wyoming

209 I wrote at length about this issue at John S. Lowe, "The Meaning of "Payout" in Oil and Gas Farmout Agreements," *supra* n. 3.

210 *Id.* at 13-20.

211 629 F.Supp. 647, 90 O&GR 234 (E.D. La. 1986).

212 629 F.Supp. at 650-651.

213 *Id.* at 651.

214 *Id.* At 654. The court quoted the testimony of an expert witness that he knew of no occasion where legal expenses arising from a dispute between the parties to the farmout agreement had been charged as an operating expense.

215 753 S.W.2d 220, 103 O&GR 633 (Tex.App.--Tyler 1988, writ. denied). Professor Kramer commented on the case in Discussion Notes, 103 O&GR 647.

216 753 S.W.2d at 222. The contract defined "payout," which was the event that triggered the shareholder's option to trade corporate stock for producing interests, as the time "when the amount of production revenue attributable to O'Keeffe's interest shall equal O'Keeffe's pro rata share of the corporation's outstanding liabilities as of November 30, 1981, plus the sum of all ordinary, necessary and reasonable expenses incurred by the corporation in producing the income during the period . . . ." *Id.* at 220.

217 783 P.2d 144, 109 O&GR 360 (Wyo.1989). Professor Gereau commented on the case at Discussion Notes, 109 O&GR 383.

Supreme Court held that losses incurred by a farmee as a result of a fire that destroyed some of its equipment could not be recovered as operating costs under a farmout agreement, when the agreement required the farmee to obtain insurance and the farmee had failed to do it. [218]

The most interesting and problematic additional "payout" case I encountered is *Howell Petroleum Corp. v. Leben Oil Corp.*[219] There, a farmee obligated by a multiple well farmout agreement to account quarterly [220] to the farmor went bankrupt, and fifteen years passed before the farmor's assignee, Howell, realized that it might have valuable rights and sought an accounting. Howell tried to avoid its obvious problems with the statute of limitations[221] by arguing alternatively that the farmout agreement made the accounting obligation either a covenant that continued as long as any of the wells subject to the farmout agreement remained in production or a covenant running with the land. The court of appeals rejected both arguments because of what it described as the "plain language" of the contract that limited its maximum term to four years and because neither Howell nor its predecessor had demanded an accounting after the contract's termination[222]

One may question the analysis of the *Howell* court. The farmout agreement provided merely that it "shall remain in existence for a maximum period of four (4) years ... ,"[223] which does not plainly state the intention of the parties that the accounting obligation end with the farmout agreement. Indeed, the parties must have known at the time they drafted the farmout agreement that payout of all the wells drilled might not have been attained within four years. A more defensible interpretation of a payout provision was given by the Texas Court of Appeals in *Cummins and Walker Oil Co., Inc.* v. *Smith.*[224] There the court held that the statute of limitations on an agreement to assign a portion of a working interest after payout began to run only after payout had occurred, because the facts that constituted the cause of action did not exist until then.[225]

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218 783 P.2d at 153-154.

219 976 F.2d 614, 121 O&GR 250 (10th Cir. 1992). Professor Kuntz commented on the case at Discussion Notes, 121 O&GR 264.

220 The accountings were to show the amount expended to date, the amount received to date and the balance left till payout. 976 F.2d at 614.

221 The trial court applied Oklahoma's five year statute of limitations for written contracts, Okla. Stat. Tit. 12, § 95, to deny Howell relief. 976 F.2d at 618.

222 976 F.2d at 619.

223 814 S.W.2d 884 (Tex.App. -San Antonio 1991).

224 814 S.W.2d 884 (Tex.App. -San Antonio 1991).

225 *Id.* at 887. *Cummins and Walker* does not involve a farmout agreement, but interprets a compensation agreement for oil company employees. The analysis is obviously relevant to farmout agreements, however.

Another analysis inconsistent with *Howell* was applied in *North Finn* v. *Cook.* [226] There, Cook farmed out portions of a mineral rights lease to Kelly Oil and Gas Co. The farmout provided that Cook would assign Kelly the working interest in a 40 acre drill site upon completion of a well capable of producing in paying quantities. The farmout also reserved Cook an overriding royalty and provided that "following payout ... , Cook shall be reassigned by Farmee, a fully participating thirty percent (30%) backing (sic) working interest in the Test Well." [227] Kelly drilled two wells, one of which was capable of producing in paying quantities, and Cook assigned a 40 acre location to Kelly. Kelly failed to pay the costs of drilling the wells and Kelly's property interests were foreclosed. North Finn purchased the foreclosed property at a sheriff's sale[228] and contended that Cook's interests were cut off as a personal covenant between Cook and Kelly.[229] The Wyoming district court characterized Cook's back-in interest as a possibility of reverter triggered by "payout" that could not be cut off by a foreclosure sale, despite North Finn's argument that the interest could not be a possibility of reverter because it was not automatic -the agreement provided that the farmee would reassign the interest. [230] The court stated that "the provision requiring reassignment by the farmee will be enforced by the Court following payout, if it occurs, as a formality signaling (sic) that reversion has occurred." [231]

Howell teaches two lessons, however. First, it suggests that a farmout agreement should be worded specifically to make the accounting obligation an obligation that will survive the termination or expiration of the agreement.[232] Second, the case shows the importance of administering one's agreements -the court's interpretation of the contract

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226 825 F.Supp. 278, 125 O&GR 613 (D. Wyo. 1993). Professor Gereau commented on the case in Discussion Notes, 125 O&GR 626.

227 825 F.Supp. at 281.

228 *Id.* at 280.

229 *Id.* at 281.

230 *Id.* at 282.

231 *Id.* The court also refused to allow statutory liens to attach to farmor's retained interest, holding that under the Wyoming statutory scheme no liens could attach to the farmor without a contract stating that the farmor will assume responsibility for the costs. *Id.* at 283.

232 The importance of specific language, at least in Oklahoma, is underscored by the fate of Howell's claim for an equitable accounting. The district court denied the claim because Howell had shown no proof that any amount was owed Howell. *Id.* at 620. The Tenth Circuit court agreed with this interpretation of Oklahoma law. *Id.* This left Howell in never-never land. Without an accounting there was no proof and without proof there would be no accounting.

language might well have been different had the original farmee been more diligent in demanding accounting statements. [233]

[8] Operating Agreements/Unit Agreements

Farmout agreements often incorporate operating agreements or unit agreements, either by attaching them or by reference.[234] What happens, however, if the farmee does not execute the agreements referenced? In *Willard Pease Oil and Gas Co.* v. *Pioneer Oil and Gas Co.,* [235] the Supreme Court of Utah held that a fact issue existed as to whether parties who executed a farmout agreement that provided in part that "by your acceptance of this Agreement you agree to adopt, ratify and confirm the plan of unitization and Operating Agreement .... " became bound by the unit agreements so as to be subject to a 300% penalty for not participating in a development well. [236] Again, we see the importance of precise words.

[9] Lease Payments

One of the important administrative problems 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 to total or partial reimbursement by the farmee. This structure usually makes administrative sense because of the efficiencies of having the farmor, who already has the farmed-out properties enrolled in its administrative system, handle the payments. [237] *Imperial Oil of North Dakota, Inc.* v. *Consolidated Crude Oil Co.,* [238] however, illustrates a risk to the farmee of relying on the farmor. In *Imperial Oil,* the North Dakota Supreme Court upheld an order of lease cancellation for failure to pay royalties even though the unpaid royalties amounted to slightly more than $12,000 and the lessee's forfeiture loss

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233 The need for diligence in asserting one's rights is also illustrated by KMI Continental Offshore Production Co. v. ACF Petroleum Co., 746 S.W.2d 238, 104 O&GR 133 (Tex. App. Houston [1sl Dist.] 1987, writ denied), where the court applied laches to bar the exercise of an option to purchase which was to be exercised within 90 days of payout, because the information as to when payout occurred was in the control of the plaintiffs. 746 S.W.2d at 244. The court observed that "the wells and land involved are oil and gas property, which is inherently speculative. The longer one delays in acting on an option concerning oil and gas property, the easier one is able to speculate on the value of the property at the other's expense." *Id.* at 244-245. Professor Horner commented on the case at 104 O&GR 147.

234 *See* SMU, *supra* n. 3, at 838.

235 899 P.2d 766, 132 O&GR 202 (Utah 1995).

236 899 P.2d at 768-769.

237 *See* SMU, *supra* n. 3, at 839-840.

238 851 F.2d 206, 100 O&GR 554 (8thCir. 1988). 851 F.2d at 210. North Dakota's statutory scheme allows cancellation of lease for failure to pay royalties. N.D. Cent. Code § 47-16-39.1 (Supp.1985).

would be approximately $691,000.[239] Further, the court held that the farmees of portions of the lessee's interests were not indispensable parties to the suit. [240] The farmees therefore lost their entire interests in the leased property without notice of the farmor's failure to pay.[241]

Imperial Oil may turn on the failure of the farmees to record their assignments, though the court does not mention that factor. It may also be that the assignments in *Imperial Oil* were unusually worded; the court observes that "the assignees ... were not parties to the leases ... the assignees were merely assigned an interest in [the farmor's] rights under the leases. [242] But if the farmees were assigned undivided interests in the farmed-out leases and recorded those interests, they should have been considered to be indispensable parties to the cancellation action.

In addition, of course, *Imperial Oil* is unusual because lease cancellation for failure to pay royalty is a remedy available in only a few states. *Cambridge Oil Co.* v. *Huggins,*[243] is a more representative decision. There a farmee failed to make timely royalty payments, breaching an amendment to a farmout agreement that gave a royalty owner the right to "terminate the agreement" for non-payment of royalty.[244] The court held that the language did not justify canceling assignments that the farmee had previously received to property surrounding producing oil wells because "courts will not declare forfeiture unless they are compelled to do so by language which can be construed in no other way.[245] The court also rejected the royalty owner's contention that the farmout agreement amendment imposed fiduciary obligations upon the farmee because the farmee had agreed to pay royalties "with more propriety than in the past,[246] distinguishing *Manges* v. *Guerra,*[247] on the ground that in *Manges,* the benefits received by the Guerras depended solely on Manges' management, while "here . . . the relationship was strictly contractual.[248]

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239 851 F.2d at 210. North Dakota's statutory scheme allows cancellation of lease for failure to pay royalties. N.D. Cent. Code § 47-16-39.1 (Supp.1985).

240 *Id.* at 211.

241 As I noted at SMU, *supra* n. 3, at 840, a related issue is what liability, if any, the farmor has to the farmee 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.

242 851 F.2d at 211.

243 765 S.W.2d 540, 106 O&GR 318 (Tex. App. --Corpus Christi 1989, writ denied). The case is the subject of a Discussion Note by Professor Horner at 106 O&GR 328.

244 765 S.W.2d at 542.

245 *Id.* at 543.

246 *Id.* at 542.

247 673 S.W.2d 180 (Tex. 1984).

248 765 S.W.2d at 544.

[10] Dealing With Bankruptcy

The possibility that one's business partners will go bankrupt inevitably enters into farmout-agreement planning. Bankruptcy may throw the solvent as well as the insolvent into turmoil, as I have previously observed.[249] Recent years have brought some good news, however, at least for farmees. In *Terry Oilfield Supply Co., Inc.* v. *American Security Bank, NA.,* [250] in holding that the owner of a production payment was entitled to a share of the proceeds of a take-or-pay settlement [251] a federal district court reasoned that a Texas oil and gas lease was not an executory contract subject to rejection by the trustee under § 365 of the Bankruptcy Code [252] because, in Texas, the lease — and a production payment carved from it — is "an interest in place," and not executory regardless of what bankruptcy lawyers may think."[253] If an oil and gas lease or production payment is not an executory interest, neither will be a conditional-assignment farmout agreement. [254]

This reasoning does not necessarily apply to those states that treat oil and gas leases as licenses or other nonpossessory interests, however.[255] So farmees greeted with relief the amendment of the Bankruptcy Code in 1992 to exclude farmed-out interests from the definition of the "property" of the bankrupt farmor's "estate,"[256] regardless of the form of the farmout as an agreement to transfer or a conditional assignment.

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249 See SMU, supra n. 3, at 862.

250 195 B.R.66 (D. S.D. Tex. 1996).

251 I am not certain that the court's conclusion is consistent with what I understand to be Texas law. See generally John S. Lowe, "Defining the Royalty Obligation," 49 *SMU* L.J. 223 (1996), reprinted at 33 PUB. LAND & RES. DIG. 257 (1996), and John S. Lowe, "Royalty Calculation in Texas," Ch. 3 in Oil and Gas Law for a New Century: Precedent as Prologue (Proceedings of the 50th Anniversary Celebration of the Southwestern Legal Foundation, Matthew Bender, 1998).

252 11 U.S.C. § 365(a) (1998).

253 195 B.R. at 73.

254 See SMU, supra n. 3, at 864-865.

255 See W. L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2D, §39:9, n. 10 (West 1998).

256 11 U.S.C. § 541(b)(4) (West 1999), which applies to all bankruptcies filed after October 24, 1992, was buried in the 300+ page Energy Policy Act of 1992. It excludes "any interest of the debtor in liquid or gaseous hydrocarbons to the extent that-(A)(i) the debtor has transferred or has agreed to transfer such interest pursuant to a farmout agreement or any written agreement directly related to a farmout agreement; and (ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 544(a)(3) of this title." Subsection (B) then specifically excludes production payments from the property of the estate. Subsection C provides that retained non-operating interests and back-in rights of a debtor are a part of the property of the estate.

But neither the court's analysis in *Terry Oilfield Supply* nor the statutory amendment completely solves the problem of the impact of bankruptcy on farmout agreements. Bankruptcy is likely to result in delays that destroy the business sense of the farmout transaction for both farmors and farmees. The business paralysis usually associated with bankruptcy is likely to cause a farmor to lose the farmed -out leases when a farmee goes bankrupt. And a farmee is likely to encounter difficulty obtaining clear title to its earned interests when a farmor goes bankrupt. [257] The financial stability of one's business partners remains a primary consideration in whether to make a deal.

IV. Conclusion

As I observed in 1987, farmors and farmees mutual interest in maximizing available tax benefits causes the structure of farmout agreements to be very much the same, or at least fall into discernable patterns. [258] Farmout substantive provisions, however, vary widely. The difference in substantive provisions results in part from the different goals that farmors and farmees seek when they enter into agreements. [259] In part, the differences are reflexive; once one encounters a problem, one drafts to avoid it in the future. In part, also, the differences show the creativity of American businessmen and their lawyers in deal-making. "Only the creativity of businessmen and their lawyers limits the variety of provisions that may be included in a farmout agreement." [260]

But surely the cases that I have reviewed in the pages above illustrate that the transactional costs of drafting, administering and litigating farmout agreements is high. Farmout agreements are susceptible to orderly analysis, and over the years many distinguished commentators have written to suggest particular approaches to that analysis.[261] Is it not time for the industry and its lawyers to try again to develop model forms?[262]

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[257] The delay that I speculate will follow a farmee's request for assignment from a bankruptcy trustee after drilling an earning well is a good reason for farmees to prefer conditional assignment farmout agreements. The delay that I speculate will follow a farmor's request for assignment of a back-in after payout is an equally good reason for farmors to prefer agreement-to-transfer farmouts. See the discussion supra in the text accompanying notes 108-123.

[258] See SMU, supra n. 3, at 765-778.

[259] *Id.* at 778-782

[260] *Id.* at 867.

[261] See *id.* at 760, n. 3, for a partial list.

[262] The AAPL has prepared a "model" form, AAPL Form 635, but it is so skeletal that it has not gained wide acceptance.