

Chapter 6

THE ANATOMY AND PREPARATION OF OCS FARMOUT AGREEMENTS

John S. Lowe⁽¹⁾

Professor of Law Southern Methodist University 214-692-2595
Dallas, TX 75275

Oil and gas farmout agreements are important devices in spreading the risks of oil and gas exploration and development on the Outer Continental Shelf, as well as in onshore operations. In fact, because both the costs and risks (as well as the rewards) of offshore development are greater than those usually associated with onshore operations, oil and gas farmout agreements may play a more important role in operations on the Outer Continental Shelf than in onshore operations.

The structure of an Outer Continental Shelf farmout agreement does not differ substantially from that of its onshore counterpart. The function of farmout agreements is essentially the same whatever the environment in which they are used. Thus, there are relatively few essential issues that determine the basic structure of the farmout agreement. I have discussed these issues at length elsewhere.¹⁽²⁾ In this paper I will simply summarize the points made in that more extensive paper and point out some interesting characteristics of OCS farmout agreements.

A. The Purpose of the Farmout

Because the farmor — the entity farming out the lease for development — generally proposes the farmout agreement, it is the farmor's purposes that are usually reflected in the agreements supplied to me for review. The farmor's reasons for farming out an OCS lease may include (1) lease preservation, (2) lease salvage, (3) risk sharing, (4) exploration and evaluation, (5) access to market, (6) obtaining reserves, (7) drilling an “obligation” well, and (8) testing a business relationship.²⁽³⁾ In each case, the farmor gives up a portion of its interest in its lease or leases to another to further what it regards as its own interest. The goals of the parties, particularly the goals of the farmor, may profoundly affect the structure of the agreement. For example, where the farmor seeks to salvage some of its investment in a lease by enticing someone else to take the risk of conducting drilling operations on it, the farmout agreement is likely to reflect very liberal terms; it suits the farmor's purpose to make the deal attractive to entice the farmee to drill. In contrast, when the farmor's primary purpose in farming out is to develop exploratory information to be used to evaluate other perspective drill sites in the area, the farmout agreement is likely to contain extensive and explicit requirements for drilling and testing.

Because large lease bonuses are generally paid for OCS leases, lease maintenance or lease salvage are probably the most common purposes of OCS farmout agreements. The best prospects are drilled early in their lease's primary terms. Drilling on less attractive prospects gets postponed from year to year until the last year of the primary term when a farmout is proposed. As a result, the terms of OCS farmout agreements are generally reasonably liberal toward the farmee, but the dates by which the farmee must perform are likely to be critical.³⁽⁴⁾

B. The Duty Imposed: Option or Obligation

Like onshore farmout agreements, most OCS farmout agreements make drilling an earning well an option rather than an obligation. Some agreements provide specifically that the farmee “may commence”

drilling, but that the farmee will earn only if a well capable of production is obtained. Others provide that the “farmee agrees to commence” the drilling of a test well but conclude that “the failure of farmee to commence the initial test well...will not result in farmee's liability to farmor for damages, but shall result only in farmee's loss of all rights under this Agreement.” Either formulation makes drilling an option rather than a obligation.

The primary significance of classifying a farmout agreement as an option farmout or an obligation farmout is the effect of the failure to perform under the agreement. When the farmout is drafted as an option to drill, failure to drill will cost the farmee the benefits it might have earned. When the farmee is obligated to drill, failure to drill may expose the farmee to very substantial liabilities for breach of its agreement. In a majority of states, including Oklahoma and Louisiana, the remedy for breach of an obligation to drill is apparently the cost of drilling the promised well.⁴⁽⁵⁾ In a minority of states, including Texas, the remedy is the benefit that the one party would have received had the other drilled the well as promised.⁵⁽⁶⁾ That benefit may be measured by the production that would have resulted had the well been drilled as promised. Other available measures of damages include the value of the retained interest or the value of the information the drilling would have developed.⁶⁽⁷⁾

C. The Substitute Well Provision

The substitute well provision of a farmout agreement addresses the rights of the parties in the event that the initial well is not drilled to completion. Generally, farmout agreements provide that if physical conditions in the hole or mechanical problems with drilling equipment prevent completion of the earning well, the farmee earns an option to drill a substitute earning well.⁷⁽⁸⁾

Substitute well provisions are especially important to a farmee where the farmee has an obligation to drill the initial well. Even where drilling is an option rather than an obligation, however, the substitute well provision may be very important to a farmee because the clause is a vehicle by which the farmee may be able to preserve the benefits that it sought to earn by entering into the farmout agreement.⁸⁽⁹⁾

Substitute well provisions are particularly important in Outer Continental Shelf farmout agreements because of the high risks and expenses associated with drilling offshore, and because of the possibility that the earning well will discover substantial quantities of hydrocarbons, but that the farmee will not wish to construct a platform in that location or may not be permitted to do so. Recognizing these risks, some offshore farmout agreements give the farmee the right to a substitute well if the initial well is not completed as a producing well without requiring that mechanical or geologic conditions prevent completion as a producer.⁹⁽¹⁰⁾

D. Defining the Objective Depth

The “objective depth,” or the “contract depth” as it is sometimes called, is the depth to which the farmee must drill 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 a description of the formation to be explored. In offshore farmout agreements, objective depth is sometimes defined by reference to mud weight, in recognition that unknown geologic circumstances make it inappropriate to designate either a definite footage or a specific target formation.¹⁰⁽¹¹⁾

Objective depth provisions are particularly important in OCS farmout agreements because the hostile environment in which OCS operations take place substantially compound the problems of ascertaining when the objective depth has been reached. Either designating the objective depth by footage or by reference to a formation may cause interpretative difficulties. Where the objective depth is measured by footage, disputes may arise over how footage is to be measured. No industry custom or usage exists as to whether a footage reference is a reference to measured depth, the distance down the hole actually drilled,

or to vertical depth, the vertical distance from the top to the bottom of the hole. Apparently, there is general agreement that the starting point for depth measurement in OCS operations is sea level. Where the method of describing the objective depth is to refer to a formation that the farmee will test, the risk arises that reasonable and prudent geologists will not agree whether that formation has or has not been tested. A device that may minimize this risk is to refer to a “control well,” another well that has tested the formation sought.¹¹⁽¹²⁾

E. Testing and Confidentiality Provisions

Lawyers sometimes pay insufficient attention to the schedule of tests required in a farmout, considering them technical boilerplate. Tests should not be so considered. Testing provisions are always an essential issue of a farmout agreement because the tests that must be performed if the farmee is to earn add substantially to the costs and risks of the farmee. Performance of the testing schedule is both a condition of earning and a substantial cost factor to the farmee.

OCS farmout agreements generally contain more extensive and explicit testing provisions than onshore farmout contracts. This difference probably follows from the fact that data from wells drilled on the Outer Continental Shelf is more valuable than data from onshore wells. The OCS is a relatively new drilling area. Fewer exploratory wells have been drilled than onshore.

Furthermore, wells are more expensive to drill in the OCS than onshore, so that fewer wells will be developed even in developed areas. As a result, there is little information available from sources other than drilling operators, and such data as is available is very expensive. It is in the farmor's interest to require the farmee to test fully the earning well and share the information.

In addition, some tests not always required in onshore farmout agreements are de facto a prerequisite to qualifying a well as capable of production in paying quantities under 30 C.F.R. § 250.11, which classifies resistivity or induction electric logs, sidewall cores and wireline formation tests and mud-logging analyses as “reliable evidence.” Because the regulation specifically designates such tests, farmout drafters frequently require them.

Offshore farmout agreements also almost always bar or limit the transfer of testing information developed.¹²⁽¹³⁾ The presence of such confidentiality provisions reflects the relative value of OCS testing information, sets up a standard for damages, and chills the casual exchange of drilling information.

F. What It Takes To Earn

What the farmee has to do to earn its interest under the farmout agreement is a key characteristic of the agreement, whether the farmout covers OCS lands or onshore properties. “Produce-to-earn” farmouts require the farmee to drill, test, and obtain production. “Drill-to-earn” farmouts require only drilling and testing.¹³⁽¹⁴⁾ In Outer Continental Shelf operations as onshore, most farmout agreements require that the farmee secure “production” in order to earn under the farmout agreement. In fact, all of the farmout agreements that I collected covering OCS operations were of the “produce to earn” type rather than the “drill to earn” type. That is not surprising; because of the relatively short length of the primary terms of OCS leases (generally five years), there simply is not a lot of time for exploration and evaluation once a lease is taken. Furthermore, as has been noted, because of high lease acquisition costs and drilling costs, the purpose of OCS farmouts is usually lease maintenance or lease salvage.

In contrast to their onshore counterparts, however, Outer Continental Shelf farmout agreements generally do not leave the determination of whether the earning well is capable of production in paying quantities to the common law. Instead, OCS farmout agreements usually specifically condition the earning of the farmee's interest upon classification of the well as capable of producing in paying quantities by the Minerals Management Service. For example:

“Should farmee drill the initial test well, substitute well or a subsequent well, to the objective depth and should the well be certified pursuant to 30 C.F.R. § 250.11 by the Minerals Management Service, and should farmee give farmor written notice of its intention to set a platform or case on to produce oil and/or gas from the farm-out lands, then said well should be deemed the earning well. Thereafter, farmor shall assign an interest in the operating rights for the farm-out lands as stated below.”

Section 250.11 of 30 C.F.R. tracks the common-law definition of “paying quantities.” “Paying quantities” is defined as “production of oil, gas, or both in quantities sufficient to yield a return in excess of the costs, after completion of the well, of producing the hydrocarbons at the wellhead.” The regulations provide how that determination is to be made by the Minerals Management Service, specifying a variety of tests that may be submitted as evidence of production capability.

In addition to drilling a well, the farmee under most OCS farmout agreements must notify the farmor in writing of its intent to build the facilities necessary to produce before it earns.¹⁴⁽¹⁵⁾ In contrast to onshore operations, one who drills offshore must always address the physical and economic problems of transporting production to market.

G. What is Earned

1. Operating Rights, Not Working Interest

Because of MMS regulations, OCS farmout agreements provide for assignment of operating rights, rather than working interests.¹⁵⁽¹⁶⁾ The farmor remains the owner of record even after the farmout acreage is earned and assigned.

2. Leases and Acreage Earned

OCS farmout agreements generally transfer to the farmee all of the farmor's operating rights in the lease block for the drilling of a single well.¹⁶⁽¹⁷⁾ In contrast, onshore agreements frequently transfer just the wellsite acreage, or the wellsite acreage and a fractional interest in acreage outside the well site. The difference in structure is as a result of economics and regulations. The costs and risks of offshore drilling are substantially greater than onshore, so that most OCS farmouts are motivated by the farmer's desire to preserve the lease and farmees generally have the bargaining power to insist upon full assignment. Moreover, the MMS policies and regulations discourage partial assignments.¹⁷⁽¹⁸⁾ Finally, drilling a single well maintains the entire OCS lease, which is usually the farmor's purpose in entering into the farmout agreement.¹⁸⁽¹⁹⁾

OCS farmout agreements generally deal with the problem of participation of the farmor in additional drilling operations before payout of the earning well by giving the farmor the option of converting its overriding royalty in the block assigned to the farmee to a working interest.¹⁹⁽²⁰⁾ The tax benefits of the intangible drilling cost deduction are preserved for the farmee by making the conversion ineffective as to the earning well until after payout.²⁰⁽²¹⁾

3. Depth Limitations

Earning depth limitations are as common in OCS farmout agreements as they are in their onshore counterparts. Typically, OCS farmouts limit the rights acquired by the farmee “from the surface down to the stratigraphic equivalent of the total depth drilled, plus 100 feet.”²¹⁽²²⁾ As I have discussed elsewhere,²²⁽²³⁾ in my opinion, the term “stratigraphic equivalent”²³⁽²⁴⁾ is over-used and uncertain of meaning. It has a deceptively precise sound, suggesting a straightforward scientific test that does not exist. In fact, “stratigraphic equivalent” has several different meanings, none of which may exist in a particular situation. If the term is to be used at all, the farmout should state a maximum footage beyond which the farmee's rights will not extend.

4. The Royalty Reservation and Payout

Like their onshore counterparts, OCS farmout agreements generally reserve an overriding royalty interest to the farmor until the earning well has paid out.²⁴⁽²⁵⁾ The overriding royalty is generally expressed in sixths, instead of eighths, however, reflecting the practice of measuring the government's royalty in sixths. In addition, as I have discussed, the overriding royalty is generally reserved in the whole block assigned, rather than in just the earning well, and is subject to conversion to a working interest should the farmee elect to drill additional wells.

Conceptually, the overriding royalty reserved may include existing burdens on the lease or exclude them.²⁵⁽²⁶⁾ Onshore agreements overriding royalty reservations frequently are of the inclusive type; e.g., the farmee reserves the difference between existing burdens and 25% of 8/8ths of production as an overriding royalty. In contrast, all of the overriding royalty reservations in the offshore farmout agreements I reviewed were of the exclusive type; i.e. the royalty was in addition to existing burdens.²⁶⁽²⁷⁾

The royalty reservation is also affected by the definition of “payout” — the point at which the farmor's overriding royalty is convertible to a portion of the working interest. Payout must not be defined more narrowly than the tax regulations permit, lest the benefits of the intangible drilling cost deduction be lost.²⁷⁽²⁸⁾ Often, OCS farmout agreements define payout to include costs that would probably not be required by the tax rules. A portion of lease acquisition costs may be included, because offshore leases are very expensive and the farmee may be required to reimburse the farmor as well as pay drilling costs. The costs of drilling platforms, well protector platforms, production platforms, pipelines or other drilling or production facilities may also be defined as costs to be recovered before payout because they add substantially to the farmee's costs of performance.²⁸⁽²⁹⁾

H. Administrative Matters

1. Suspension of Production

Even if an offshore well is capable of production in paying quantities, the OCS lease may be lost if there is no actual production unless the operator files for suspension of production approval²⁹⁽³⁰⁾ and supports its application with a Schedule of Development.³⁰⁽³¹⁾ Since the farmee has an economic incentive to make the filing and preserve the lease, most offshore farmout agreements do not address this potential problem, other than to place the burden of filings generally on the farmee. If the earning well is capable only of marginal production, however, the interests of the farmee and the farmor may not be the same. One drafting device might be to expand the reassignment clause of the farmout to extend to the farmor the right to demand reassignment of the lease unless the farmee files for a suspension of production order on a non-producing lease within a reasonable time of the determination that the earning well is capable of producing in paying quantities. Another device is to designate the farmor as operator for the purpose of filing for the suspension of production approval. For example:

Suspension of Production Approval. Should the Initial Well or any Subsequent Well(s), if any, drilled under the terms of this Farmout Agreement be completed as one capable of producing oil and/or gas as provided in 4.1(a), Farmee will apply for and diligently seek any approval of a Suspension of Production covering the Lease from the Minerals Management Service, if same is necessary, to maintain the Lease in force and effect. In the event Farmee fails to diligently seek approval of a Suspension of Production by _____, Farmor shall have the right at Farmor's option to be designated Operator for the purpose of seeking such a suspension of Production.

The farmor should have a vehicle to preserve the lease even if the farmee does not choose to do so.

2. Recording of Assignments

In addition, OCS assignments, like assignments of rights to onshore federal leases, should probably be recorded in the appropriate state land records to avoid argument whether filing with the MMS is sufficient to establish constructive notice.³¹⁽³²⁾ Generally, assignments pursuant to OCS farmout agreements are filed in the land records of the county adjacent to the offshore area in addition to the appropriate office of the MMS.

In dealing with OCS leases as with all federal leases, a question arises as to whether Department of Interior approval is necessary for the farmout agreement itself as an assignment of rights. Both practice and conventional wisdom apparently are to the contrary.³²⁽³³⁾ Where an assignment of record title or operating rights is made in the farmout at the time the agreement is executed, however, there probably is a requirement under the Interior Department's assignment regulations that the farmout agreement be filed even though record title is not earned until the earning well is completed.³³⁽³⁴⁾ Because of tax and bankruptcy considerations,³⁴⁽³⁵⁾ present assignments of interest are frequently used in farmout agreements. Where the present assignment form of farmout is used, an assignment of operating rights must be filed on the Department's prescribed form within ninety days.³⁵⁽³⁶⁾

According to the Law of Federal Oil and Gas Leases, the policy of the Department of Interior is to decline to approve assignments which provide for automatic termination and reversion to the grantor.³⁶⁽³⁷⁾ This throws into question the common structure of farmout agreements of the present assignment type. Most present assignment farmouts are drafted so that the farmee is given a sublease of rights by the farmor that automatically terminates if drilling operations are not commenced within the agreed time. Again, according to the Law of Federal Oil and Gas Leases, however, if such a farmout also includes a reassignment provision obligating the farmee to reassign the lease to the farmor in the event that the sublease expires, then the assignment will be accepted for filing and approved.³⁷⁽³⁸⁾ Most farmout agreements contain specific provisions for reassignment in order to avoid a possible cloud on title. In dealing with OCS farmout agreements, there is an additional regulatory reason for the reassignment provision.

I. Liability, Insurance and Indemnification Provisions

There is greater liability exposure in OCS farmout agreements than under onshore agreements for both farmees and farmors. The OCS is a dangerous work environment, which increases the risk that injury or damage will occur that will subject the farmee to liability. The often-dangerous conditions also increase the risks of vicarious liability under one of the "usual" vicarious liability theories such as mining partnership or joint venture. OCS farmout agreements often include language disclaiming such liabilities, but such "bootstrap" efforts may be worth little more than the paper upon which they are written.³⁸⁽³⁹⁾

The risk of liability as a record owner is also broader in OCS farmout agreements than in onshore operations. One reason is Minerals Management Service regulations, which require the designation of a single operator of record for a lease.³⁹⁽⁴⁰⁾ The MMS looks primarily to the operator and the lease owner to fulfill obligations imposed by the statutes, regulations and lease terms. For a variety of reasons, the farmee may not be designated as the lease operator. Thus, the farmor (or possibly a contract operator) may find itself confronting claims from the MMS for alleged failures of the farmee.

In addition, federal statutes and regulations impose generally broader liability upon record title owners than does state law. For example, as a general rule, a leasee of fee mineral interests is not liable for injuries or losses caused by a farmee or a contractor.⁴⁰⁽⁴¹⁾ In contrast, the federal regulations governing OCS operations specifically impose the duty to perform safe and workman-like operations

upon the lease.⁴¹⁽⁴²⁾ Another example is the offshore Oil Spill Pollution Fund Act,⁴²⁽⁴³⁾ which imposes joint and several liability for pollution upon both the owners and operators of offshore oil facilities.⁴³⁽⁴⁴⁾

The insurance and indemnification provisions of OCS farmout agreements are more important than those in onshore farmout contracts⁴⁴⁽⁴⁵⁾ because the costs and risks of liability, as well as the scope of liability, are greater in operations on the Outer Continental Shelf. If a drilling rig collapses offshore both the resulting loss of life and the cost of recovering it are likely to be substantially greater than onshore. Onshore drilling rigs are not at risk of being hit by ships or crashed by helicopters. If pollution occurs, the liability may be much greater and far reaching in Outer Continental Shelf operations than onshore. As a result, insurance provisions in OCS farmout agreements generally set higher minimum coverages than onshore agreements and require types of coverage not usually seen in onshore operations, notably watercraft liability insurance,⁴⁵⁽⁴⁶⁾ aircraft liability insurance,⁴⁶⁽⁴⁷⁾ well control and environmental insurance,⁴⁷⁽⁴⁸⁾ and insurance to cover liabilities under legislation peculiar to maritime operations.⁴⁸⁽⁴⁹⁾ In addition, offshore farmouts usually contain provisions disclaiming joint liability.⁴⁹⁽⁵⁰⁾

Indemnification clauses in farmout agreements go hand in hand with insurance provisions.⁵⁰⁽⁵¹⁾ Because liability limits may be exceeded or insurance carriers may deny liability, most OCS farmout agreements contain clauses requiring the farmee to indemnify the farmor against liability.⁵¹⁽⁵²⁾ A discussion of indemnification provisions and the Texas and Louisiana Anti-Indemnity statutes has preceded this paper.

J. Conclusion

Farmout agreements play an important role in the exploration and development operations of the oil and gas industry worldwide. There is no standard form for such agreements, but there are commonly-encountered issues that are essential to their effectiveness. An analysis based upon those essential issues is the best way that I know to analyze the similarities and differences of farmout agreements.

Endnotes

1 (Popup - Vol 24A Ch 6 Fn *)

*Copyright John S. Lowe, 1989. I thankfully acknowledge the assistance of the following in preparing this paper: James R. Coffee, Dallas; Wayne Cummings, Dallas; Victor R. Day, Tulsa; Douglas Fant, Houston; Robert F. LeBlanc, Tulsa; Robert L. Muth, Dallas; Edward B. Poitevent, III, New Orleans; Harry W. Sullivan, Jr., Dallas; Jeanmarie B. Tade, Houston; and Lawrence A. Uter, Dallas.

2 (Popup - Vol 24A Ch 6 Fn 1)

¹See generally Lowe, “Analyzing Oil and Gas Farmout Agreements,” 41 Sw.L.J. 759 (1987).

3 (Popup - Vol 24A Ch 6 Fn 2)

²For further discussion of the purposes that may motivate the farmor and the farmee to enter into a farmout agreement see Lowe, supra [note 1](#) at 778-782.

4 (Popup - Vol 24A Ch 6 Fn 3)

³In contrast to the regulations governing federal leases onshore, 43 C.F.R. § 3107.1, the regulations governing OCS operations do not specifically require “actual drilling operations” to maintain a lease at the end of its primary term. Section 250.13 of 30 C.F.R. merely requires “producing, drilling, or well-reworking operations” to continue the lease. Apparently, however, the MMS position is that the reference to “drilling” in the regulations is not satisfied unless the well is spudded.

5 (Popup - Vol 24A Ch 6 Fn 4)

⁴*Fite v. Miller*, 196 La. 876, 200 So. 285, 286 (1940); *Ardizzone v. Archer*, 72 Okla. 70, 178 P. 263, 265-66 (1919). These cases deal with breach of a drilling covenant in a lease. Professors Williams and Meyers have asserted, however, that the problems are the same in the context of breach of a farmout agreement as they are in a breach of a lease, so that the rules should be the same. See 2 H. Williams and C. Meyers, *Oil and Gas Law* § 432.2 (1988). Professor Williams also cites cases from the federal courts as adopting the cost of drilling rule.

6 (Popup - Vol 24A Ch 6 Fn 5)

⁵See, *Guardian Trust v. Brothers*, 59 S.W.2d 343, 345 (Tex. Civ. App. — Eastland 1933, writ ref'd). Professor Williams cites cases from the federal courts, as well as from courts in California as adopting the loss of benefit rule. See 5 H. Williams and C. Meyers, *Oil and Gas Law* § 885.2.

7 (Popup - Vol 24A Ch 6 Fn 6)

⁶For further discussion of the implications of drilling as an option or an obligation see Lowe, supra [note 1](#) at 811-814.

8 (Popup - Vol 24A Ch 6 Fn 7)

⁷For example:

If during drilling the initial test well farmee encounters impenetrable substances or conditions, including loss of the hole due to mechanical difficulties, which in the opinion of a reasonably prudent operator under the same or similar conditions would render further drilling impracticable or hazardous, and such substances or conditions prevent drilling of the well, at a mutually acceptable surface and bottomhole location, to the objective depth, farmee may commence a substitute well, provided actual drilling of this substitute well is commenced within sixty (60) days after release of the drilling rig used for the initial test well and is drilled pursuant to all the terms and provisions of this Farmout Agreement applicable to the initial test well.

9 (Popup - Vol 24A Ch 6 Fn 8)

⁸For a more complete discussion of the substitute well clause in farmout agreements, see Lowe, supra [note 1](#) at 814-818.

10 (Popup - Vol 24A Ch 6 Fn 9)

⁹For example:

In the event Farmee has drilled the Initial Test Well, or any substitute well therefor, but such well is not completed as a well producing or capable of producing hydrocarbons in paying quantities (as determined by application of the provisions of 30 C.F.R. 250.11 or as mutually agreed to by all signatory parties hereto), Farmee shall earn no interest in the Farmout Acreage, but shall have the option to drill a subsequent well or wells on the Farmout Acreage in an effort to earn an interest therein. If Farmee elects to drill a subsequent well or wells, such well(s) shall be committed to within forty-five (45) days and actually commenced within ninety (90) days after release of the rig from the last well drilled by Farmee on the Farmout Acreage and any such subsequent well or wells shall be drilled under the same terms and conditions as those specified in this Agreement for the Initial Test Well. If any subsequent well is completed as a well producing or capable of producing hydrocarbons in paying quantities (as determined by application of the provisions of 30 C.F.R. 250.11 or as mutually agreed to by all signatory parties hereto), Farmee shall earn the rights to the Farmout Acreage as specified in this Agreement for the Initial Test Well, or any substitute well therefor. (Emphasis added).

11 (Popup - Vol 24A Ch 6 Fn 10)

¹⁰For example:

Within ninety (90) days of execution of this letter by all parties, subject to the availability of a suitable drilling rig, Farmee shall commence, or cause to be commenced, the actual drilling of a well (hereinafter referred to as the “test well”) on the Farmout Acreage at a surface location and bottomhole location of its choice. Such well shall be drilled in a diligent and workmanlike manner to a vertical depth of _____ or to a depth where the mud weight equals or exceeds _____ pounds per gallon, whichever is a lesser depth, such depth being hereinafter referred to as “contract depth.”

12 (Popup - Vol 24A Ch 6 Fn 11)

¹¹For example:

On or before _____, 19__ Farmee may commence the actual drilling of a test well, at a mutually acceptable surface and bottomhole location in the _____ of Block _____, hereafter referenced as the “initial test well,” and thereafter prosecute the drilling of said well to a minimum true vertical depth of _____ feet, or, if applicable, the stratigraphic equivalent of the “ ” Sand as seen on the dual induction log of the well drilled on Block OCS-G whichever is lesser, hereafter referenced as “objective depth.” In no event shall the initial test well exceed nor shall _____ earn any interest below the maximum true vertical depth of _____. The costs, risks and expense of drilling the initial test well to the objective depth, including equipping and testing, shall be borne exclusively by Farmee. (Emphasis added.)

For further discussion of problems of objective depth in farmout agreements, see Lowe, [supra note 1](#) at 805-808.

13 (Popup - Vol 24A Ch 6 Fn 12)

¹²For example:

The parties agree that all geophysical, geological, engineering, technical, and production tests or other data obtained from all wells drilled under this Farmout Agreement shall be the property of the parties to this Farmout Agreement and shall be maintained as confidential information for a period of ten (10) years from the effective date of this Farmout Agreement, or until such information is made public by an appropriate governmental authority, or unless the parties agree

in writing to a lesser period of time.

Notwithstanding any provision of this Farmout Agreement, any party may disclose without the consent of the other parties any information (1) it is required to disclosed by any contract providing for advance funding or incentive funding, (2) to an outside party with which it is engaged in a bona fide negotiation to contract for advance funding or incentive funding or Gas Sales Agreements, (3) to a governmental agency when required by such agency, (4) to reputable financial transaction, (5) to accredited engineering firms for the purpose of evaluation on a confidential basis, (6) to reputable and financially responsible third parties with whom a party is engaged in a bona fide effort to effect a merger or consolidation or which third party proposes to acquire all or a controlling part of the stock in party hereto or to purchase all or substantially all of the assets of a party hereto or affiliates of parties hereto, provided that any third party permitted access to confidential data shall agree in writing not to communicate such information to anyone and further agree to make no use of such information adverse to the parties hereto within the area covered by such information during the period of time such information remains confidential hereunder; and provided further that the party disclosing the confidential data shall indemnify and hold the other party hereto harmless against losses resulting from its disclosure to non-governmental third parties. The foregoing confidentiality provision shall not apply to a party to the extent that such affiliate is bound by written agreement to keep the information confidential. A copy of any confidential agreement required hereunder shall be provided to Farmor prior to disclosure.

14 (Popup - Vol 24A Ch 6 Fn 13)

¹³A produce-to-earn farmout generally requires that the farmee must secure production in paying quantities, as well as drill and test the earning well, to earn. Produce-to-earn farmouts are the norm where the purpose of the farmout is to preserve the underlying lease. A drill-to-earn farmout requires less; the farmee can earn by drilling to the objective depth and testing even though production in paying quantities is not obtained. For further discussion, see Lowe, supra note 1 at 793-794, 808-810.

15 (Popup - Vol 24A Ch 6 Fn 14)

¹⁴The clause quoted in the immediately preceding note continues:

The assignment shall convey all of Farmor's right, title and interest in and to the operating rights in the farmout lands from the surface to the stratigraphic equivalent of 100 feet below the deepest true vertical depth drilled in the earning well. (Emphasis added).

16 (Popup - Vol 24A Ch 6 Fn 15)

¹⁵For example:

Should Farmee drill the initial test well, substitute well or a subsequent well, to the objective depth and should the well be certified pursuant to 30 CFR 250.11 by the Minerals Management Service, and should farmee give Farmor written notice of its intention to set a platform or caisson to produce oil and/or gas from the farmout lands, then said well shall be deemed the earning well. Thereafter, Farmor shall assign an interest in the operating rights for the farmout lands as stated below.

17 (Popup - Vol 24A Ch 6 Fn 16)

¹⁶See the example clause in the preceding note. Infrequently, as offshore farmout agreement will cover and assign a portion of a lease block; e.g., where the lease is held by production from a platform on one part of the block, but the owner does not wish or cannot afford to build a platform on the remaining portion of the block.

18 (Popup - Vol 24A Ch 6 Fn 17)

¹⁷MMS policy is not to approve assignments of operating rights to less than a quarter block.

Furthermore, 30 C.F.R. § 250.190 et. seq. establishes a regime for pooling that discourages partial block assignments.

19 (Popup - Vol 24A Ch 6 Fn 18)

¹⁸30 C.F.R. § 250.13.

20 (Popup - Vol 24A Ch 6 Fn 19)

¹⁹For example:

The overriding royalty interest to be reserved in favor of Farmor as provided above shall be subject to an option to convert said override into a _____ percent (_____%) of six-sixths (6/6ths) working interest. The reserved override as well as any working interest conversion shall be proportionately reduced if Farmor owns less than 100% of the working interest in the Earned Acreage. The option for Farmor to convert to a working interest in the Earned Acreage shall begin upon the earlier of the following occurrences: (a) within thirty (30) days of receipt of notice from Farmee that their receipts, less royalties, including the herein reserved overriding royalty interest and taxes from the sale of production from the Earning Well are equal to the cost of drilling, testing and completing and equipping as capable of production the Earning Well, together with the cost of operating such well during the payout period; or (b) within thirty (30) days of receipt of notice from Farmee of their intent to commence an subsequent well on the Earned Acreage, together with information regarding the location, depth, and estimate cost of the well, or (c) within sixty (60) days of receipt of notice from Farmee of their interest to set a platform to develop the Earned Acreage. If the Farmee elects to begin operations on a subsequent well (of which they shall have given notice as provided in (b) above) prior to expiration of the thirty-day notice period, Farmor shall not be entitled to receive data from that well until such time as it has notified Farmee in writing of its election with respect to whether to convert its reserved overriding royalty interest to a working interest, as above provided. If, upon the occurrence of events described in (b) or (c) above, Farmor does elect to convert its overriding royalty interest to working interest, such conversion shall be suspended solely as to the Earning Well until such time as payout thereof shall have occurred, at which time the conversion shall then become effective in regard thereto.

21 (Popup - Vol 24A Ch 6 Fn 20)

²⁰See the last sentence of the clause [supra note 19](#).

22 (Popup - Vol 24A Ch 6 Fn 21)

²¹See, e.g., the clause [supra note 15](#).

23 (Popup - Vol 24A Ch 6 Fn 22)

²²Lowe, [supra note 1](#) at 825-827.

24 (Popup - Vol 24A Ch 6 Fn 23)

²³Generally, “stratigraphic equivalent” is intended to give the farmee the right to the benefits of its risk-taking by awarding it the right to the sedimentary strata it has drilled at whatever depth they are found.

25 (Popup - Vol 24A Ch 6 Fn 24)

²⁴Lowe, [supra note 1](#) at 768, 829-830.

26 (Popup - Vol 24A Ch 6 Fn 25)

²⁵For discussion and examples, see Lowe, [supra note 1](#) at 830-832.

27 (Popup - Vol 24A Ch 6 Fn 26)

²⁶For example:

[The assignment shall] Reserve to Farmor an overriding royalty interest (ORRI) of _____ of

6/6ths of all liquid and/or gaseous hydrocarbon substances produced and/or saved, either through testing of the earning well or production of the earning well, from or attributable to the farmout lands.

28 (Popup - Vol 24A Ch 6 Fn 27)

²⁷For discussion of the intangible drilling cost deduction and the complete payout limitation, see Lowe, [supra note 1](#) at 776-768, 833-836.

29 (Popup - Vol 24A Ch 6 Fn 28)

²⁸For example:

Payout. Payout shall occur when the “Net Proceeds,” as hereinafter defined, from the sale of all production, on a well by well basis from the Initial Well or any Subsequent Well(s) equals the total tangible and intangible costs of drilling, sidetracking, equipping (an oil well through the oil storage tanks and a gas well through the Christmas tree), testing, completing said well for production, and operating said well prior to payout provided such costs shall not include platform costs or the cost of facilities which also serve other wells with a bottomhole location outside the Farmout Area except as to the cost of using the platform from which the well is operated and using such facilities allocated as follows:

(a) The expense of operating and maintaining said platform shall be allocated equally to all completions served.

(b) The expense of operating and maintaining facilities which also serve other wells shall be allocated on a volume throughput basis; that is to say, in the proportion that the volume throughput of said well bears to the total volume throughput of all wells connected to the facilities.

30 (Popup - Vol 24A Ch 6 Fn 29)

²⁹Pursuant to 30 C.F.R. § 256.73, suspension of production order suspends the running of the lease primary term of maintains a lease in its secondary term. 30 C.F.R. § 250.10 spells out the procedure to file for a suspension of production order and defines appropriate grounds for approval.

31 (Popup - Vol 24A Ch 6 Fn 30)

³⁰30 C.F.R. § 250.34-2. See the discussion at Martin, “Outer Continental Shelf Leases,” The Law of Federal Oil and Gas Leases § 25.07[4] (Rocky Mountain Mineral Law Foundation 1985).

32 (Popup - Vol 24A Ch 6 Fn 31)

³¹For a discussion of the issue, generally, see Lear, Lurking Title Problems: Snares for the Unsuspecting Federal Oil and Gas Lease Title Examination, [25 Rocky Mtn. Min. L. Inst.](#) 18-1, [18-25](#) to [18-36](#) (1979).

33 (Popup - Vol 24A Ch 6 Fn 32)

³²See generally, Terrell, “Assignments and Transfers of Interest,” The Law of Federal Oil and Gas Leases § 10.07[1] (Rocky Mountain Mineral Law Foundation 1985).

34 (Popup - Vol 24A Ch 6 Fn 33)

³³Terrell, [supra note 28](#) at § 10.07[2].

35 (Popup - Vol 24A Ch 6 Fn 34)

³⁴Lowe, [supra note 1](#) at 759, 796, 773-75, 864-865. With a present assignment farmout, the farmee gets an assignment of interest or operating rights at the time the farmout agreement is executed. More usually, for administrative convenience, the farmee gets no assignment of interest or operating rights until it has fully performed the farmout agreement.

36 (Popup - Vol 24A Ch 6 Fn 35)

³⁵43 C.F.R. §§ 3106.1(a), §§ 3106.4-1.

37 (Popup - Vol 24A Ch 6 Fn 36)

³⁶Terrell, [supra note 32](#) at § 10.07[2].

38 (Popup - Vol 24A Ch 6 Fn 37)

³⁷Id.

39 (Popup - Vol 24A Ch 6 Fn 38)

³⁸For example:

Except as stated in Article IX above [an indemnification provision], Farmor and Farmee hereby agree that the respective obligations and liabilities of the parties under this Farmout Agreement shall be several, not joint or collective, and each party shall be responsible for its own obligations. It is not the intention of the parties to create, nor shall this Farmout Agreement be construed as creating, a mining or other partnership, agency or association between the parties or to render them liable as partners, agents or associates.

For discussion of vicarious liability theories general in Farmout Agreements, see Lowe, [supra note 1](#) at 852-855.

40 (Popup - Vol 24A Ch 6 Fn 39)

³⁹30 C.F.R. § 250.8.

41 (Popup - Vol 24A Ch 6 Fn 40)

⁴⁰It is a fundamental principle of tort and contract law that one is not liable for the actions of an independent contractor or third party with an interest in the lease. Often, fee oil and gas leases specifically embrace that principle by providing that the lessee is absolved from liability, except for its own actions, after a partial assignment. Of course, the vicarious liability theories limit this general principle.

42 (Popup - Vol 24A Ch 6 Fn 41)

⁴¹30 C.F.R. § 250.20.

43 (Popup - Vol 24A Ch 6 Fn 42)

⁴²43U.S.C. §§ 1811-1824 (1986).

44 (Popup - Vol 24A Ch 6 Fn 43)

⁴³Id. at § 1814.

45 (Popup - Vol 24A Ch 6 Fn 44)

⁴⁴For a discussion of insurance provisions in farmout agreements generally, see Lowe, [supra note 1](#) at 856-857.

46 (Popup - Vol 24A Ch 6 Fn 45)

⁴⁵For example:

WATERCRAFT LIABILITY INSURANCE — [Farmee's coverage to include] Full conditions Hull and Machinery Insurance, including war risks and collision liability, in an amount at least equal to the market value of the vessel and its equipment. Full conditions Protection and Indemnity Insurance, including pollution liability and removal of debris, in an amount not less than \$5,000,000.00 or the value of the vessel, whichever is greater. Umbrella Liability Insurance, over and above the Protection and Indemnity Insurance coverage noted above in an amount not less than \$2,500,000.00.

47 (Popup - Vol 24A Ch 6 Fn 46)

⁴⁶For example:

AIRCRAFT LIABILITY INSURANCE — [Farmee's coverage to include] Aircraft Hull “All Risk” Insurance on the market value of the aircraft. Aircraft Liability Insurance with a combined single limit of \$10,000,000.00 per occurrence for bodily injury and property damage, including passenger

liability with a limit of not less than \$500,000.00 per passenger seat; contractual liability applicable to the Farmout Agreement to which this Exhibit “B” is attached.

48 (Popup - Vol 24A Ch 6 Fn 47)

⁴⁷For example:

OPERATOR'S EXTRA EXPENSE COVERAGE — [Farmee's coverage] To include seepage and pollution liability and control of well coverage, underground blowout and redrill coverage with limits of not less than \$5,000,000.00.

49 (Popup - Vol 24A Ch 6 Fn 48)

⁴⁸For example:

[In addition to Worker's Compensation and Employers' Liability insurance, Farmee shall obtain]:

3. Maritime endorsements to cover liability under:

- (a) Longshoremen and Harbor Worker's Compensation Act (including its extension for Outer Continental Shelf Lands Operations)
- (b) Admiralty Jurisdiction
- (c) Jones Act
- (d) Marine and Voluntary Compensation with a liability limit of not less than \$1,000,000.00 per accident

(e) Employer's Liability coverage for masters and crew of FARMEE's vessels used in operations with a minimum liability limit of \$100,000.00 for all injuries or deaths arising out of one accident.

50 (Popup - Vol 24A Ch 6 Fn 49)

⁴⁹See Lowe, [supra note 1](#) at 855, note 431. Whether such disclaimers will be given effect is problematic.

51 (Popup - Vol 24A Ch 6 Fn 50)

⁵⁰For example:

Farmee shall indemnify and hold Farmor harmless, to the maximum extent permitted by law, from and against any claims for injury, death or damage of every kind and character to persons or property arising out of or in connection with Farmee's operations under the terms of this Farmout Agreement upon any of the farmout lands, including deriving from acts of Farmee's contractors, subcontractors, successors and assigns; provided that if any suit is filed on any claim, Farmee shall immediately notify Farmor and permit Farmor to participate in the defense thereof without waiver or impairment of Farmee's indemnities to Farmor. It is the expressed intention of the parties hereto, both Farmee and Farmor, that the indemnity provided in this Article is indemnity by Farmee, and Farmee's contractors, subcontractors, successors and assigns to indemnify and protect Farmor from the consequences of Farmor's own negligence, whenever that negligence is the concurring cause of the injury, death, or damage.

The last sentence of the quoted clause obligates the farmee to indemnify the farmor for its own negligence. In many instances, this will not be effective, either because the language conflicts with state Anti-Indemnity Statutes or because it is insufficiently clear. See generally, the preceding paper by Jeanmarie B. Tade discussing Anti-Indemnity Statutes in the context of OCS operations. See also *Atlantic Richfield Company v. Petroleum Personnel, Inc.*, 758 S.W.2d 843 (1988), writ granted, holding that language requiring Petroleum Personnel to indemnify Atlantic Richfield Against “any negligent act or omission” of Atlantic Richfield was insufficient to define the parties' intent under the express negligence doctrine, which permits indemnification of a party from the consequences of its own negligence where that intent is “specifically stated within the four corners of the contract.” *Ethyl Corp. v. Daniel Constr.*

Co., 725 S.W.2d 705, 708 (Tex. 1987).

52 (Popup - Vol 24A Ch 6 Fn 51)

⁵¹For a discussion of indemnification provisions in farmouts generally, see Lowe, [supra note 1](#) at 857-860. For the comprehensive treatment of the subject see Tade, The Texas and Louisiana Anti-Indemnity Statutes As Applied to Oil and Gas Industry Offshore Contracts, 24 Hous. L. Rev. 665 (1987).