Anatomy of a Farmout Agreement

Tjornehoj & Hack LLC

Jon Tjornehoj, Managing Partner

Alex Finch, Associate Attorney

www.THLawGroup.com

The Basics

Farmout Agreement:

Assignment of WI, reserving ORRI, in exchange for drilling of test well

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Farmor:

E&P Company who owns the working interest in a lease

Farmee:

E&P Company who is capable of drilling a test well

The Purpose

Farmor Goals

- Lease Preservation
- Lease Salvage
- Shift drilling costs
- Exploration

Farmee Goals

- Utilize sitting capital
- Share drilling costs
- Operating expertise
- Acquire new acreage

Variations allow prioritization of particular incentives

Farmout Variations

Duty to Drill

Option to drill test well vs. Obligation to drill

Initial Test Well

Single test well vs. Multiple test wells

Duty to Produce

Drill to earn vs. Produce to earn

Earned Interest Basis

Single lease, multiple leases, or drilling unit

Convertible ORRI

Option to convert vs. Automatic conversion

Variations to Achieve Goals

<u>Farmor Incentives</u>

- Lease Preservation

Duty to Drill

Option to Drill

vs.

Obligation to Drill

Duty to Produce

Drill to earn

vs.

Produce to earn

Variations allow prioritization of particular incentives

Basic Structure

I. Identification of Farmor/Farmee

II. Description of Subject Lands

III. Conditions for drilling the test well

IV. Assignment of Interest

  a. Convertible ORRI & Payout

V. Payout Account & Reporting

VI. Attached exhibits

Assignment & Reservation

Assignments:

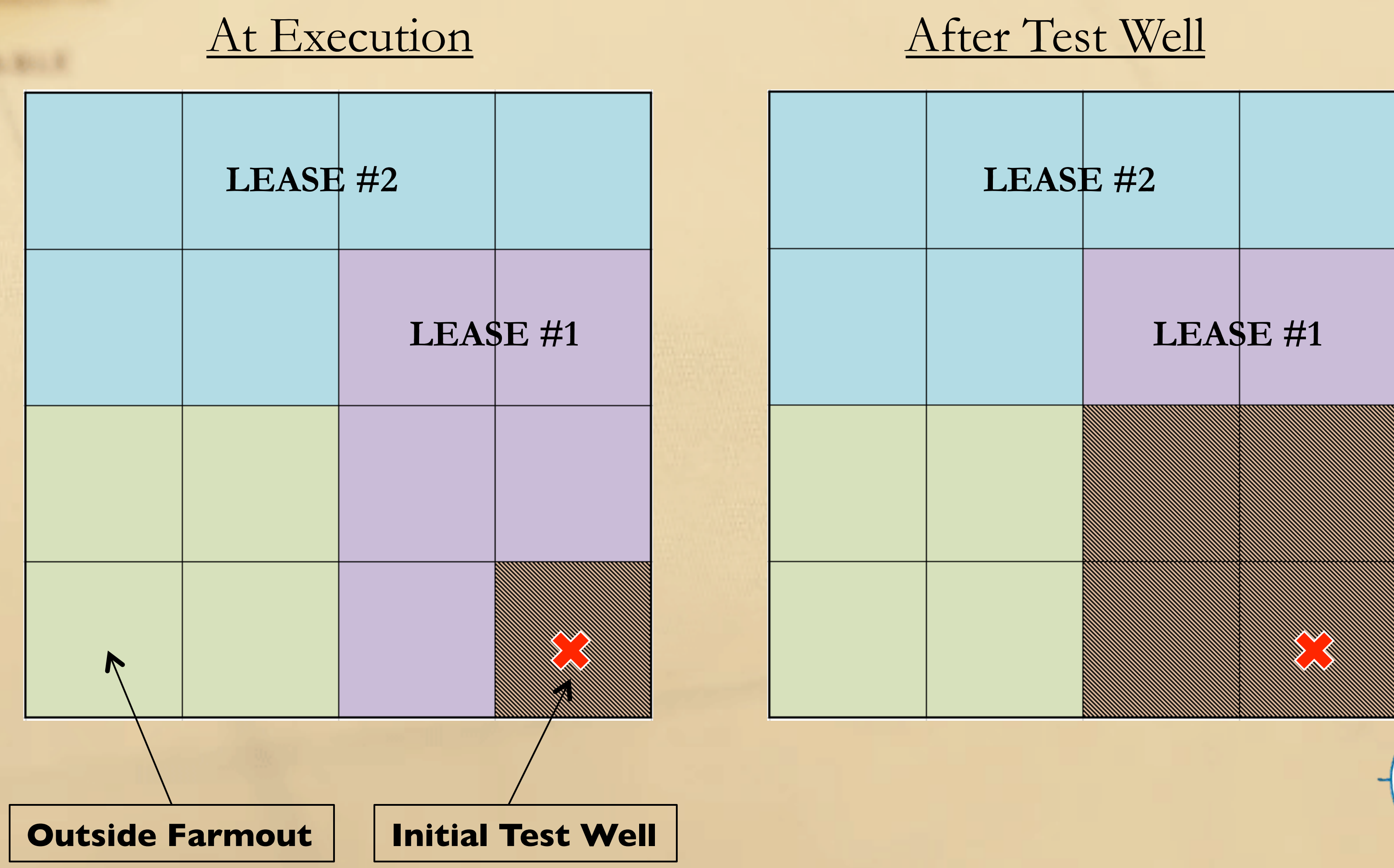
"Upon completion of the Initial Test Well in accordance with the provisions… herein, [the Farmor] will execute and deliver to [Farmee] an assignment of 50% of the operating rights and working interest of [the Subject Lease] and subject to its proportionate share of existing overriding royalties and other burdens"

Reservation of ORRI:

"excepting and reserving to [Farmor], as to production of oil and gas from or allocated to [Subject Lands] included within the drilling and spacing unit for such [Initial Test Well], an overriding royalty of 5% of 8/8, which shall be exclusive of and in addition to existing non-operating lease burdens"

Earned Interest Basis

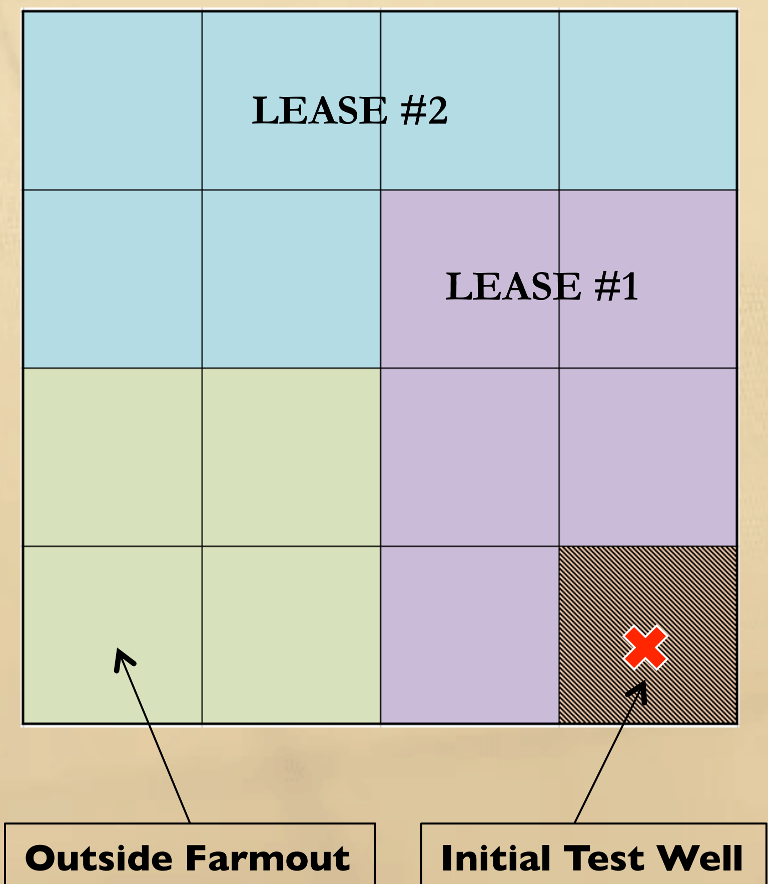
Partial Leasehold Interest



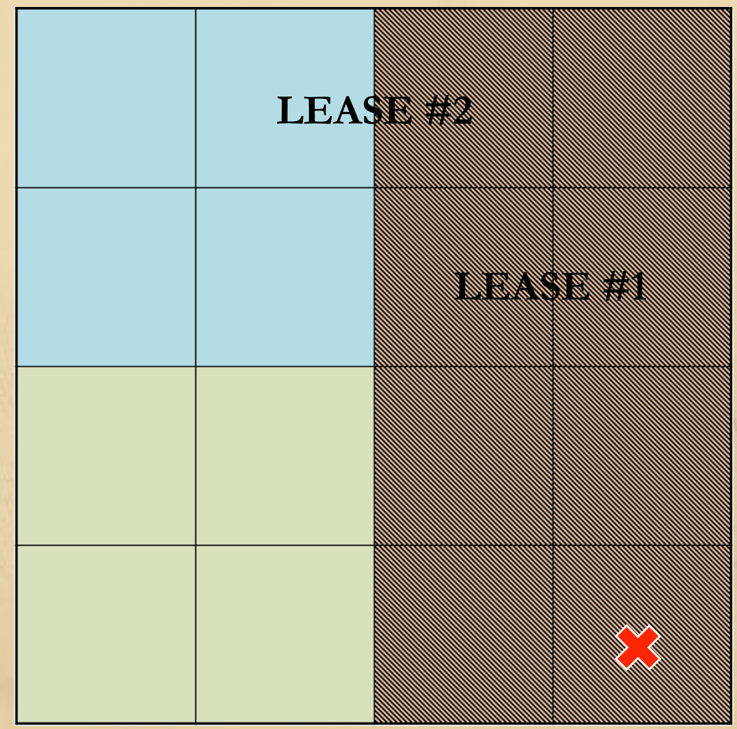
Earned Interest Basis

Drilling Unit Comprised of Multiple Leases

At Execution



After Test Well



E2 = Drilling Unit

Convertible ORRI & Payout

Convertible ORRI:

"…the overriding royalty interest of [the Farmor] hereunder will automatically convert to 50% of the operating rights and working interest in the drilling and spacing unit assigned hereunder and in the well and all material and equipment therein and thereon."

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

"[on the day in which] the proceeds of production of oil or gas… allocated to [the Farmee] within such drilling and spacing unit… equal the share of all costs of drilling, testing, completing and equipping the Test Well which is proportionate to the net leasehold acres of [the Farmor] in such drilling and spacing unit…"

"Back-in Interest" = WI owned APO

Payout Accounting & Reporting

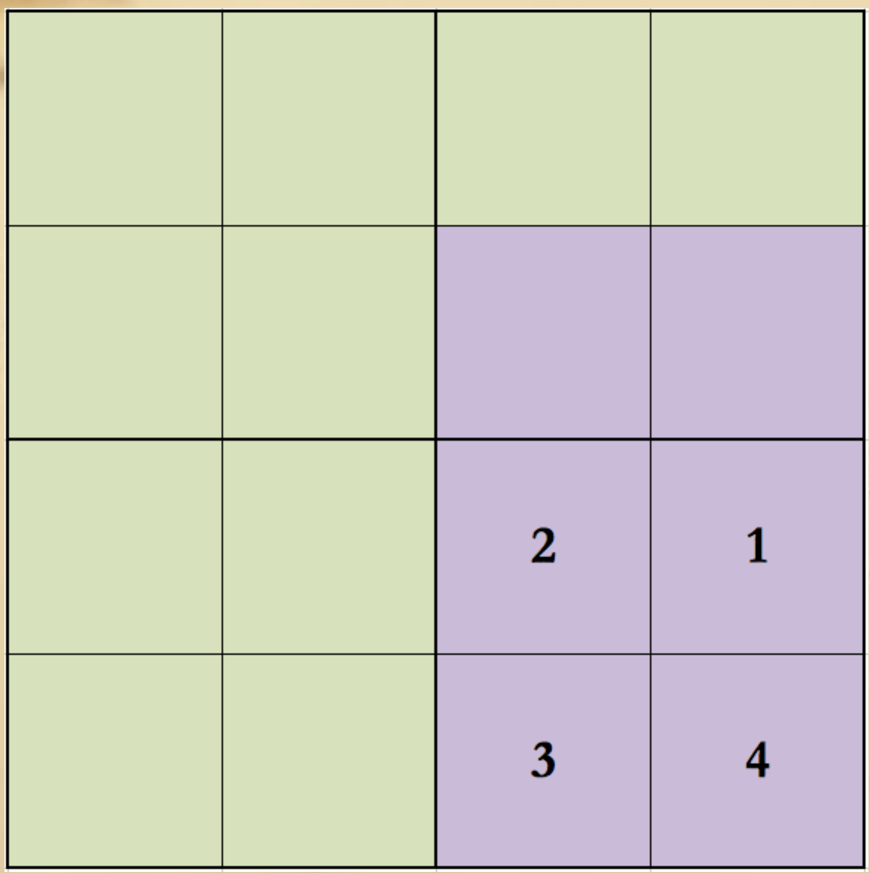
Time Period:
-after completion
-production occurring

Payout Status:
PAYOUT

<u>Proceeds vs. Costs</u>

Option to Convert

On what basis?



Example Scenario:

BPO

Farmor: 5% ORRI

Farmee: 100% WI

[Well #1 achieves Payout]

APO

Farmor: 50% WI

Farmee: 50% WI

in what?

Wellbore vs. Leasehold

Option to Convert

On what basis?

Leasehold

Before Payout

Party	Interest
Landowner	12.5% LRI
Farmor	5% ORRI
Farmee	100% WI

After Payout

	est
Lando	% LRI
Farm	% WI
Far	WI

Wellbore

Party	Interest
Landowner	12.5% LRI
Well No. 1 - APO	
Farmor	50% WI
Farmee	50% WI
Well No. 2 – BPO	
Farmor	5% ORRI
Farmee	50% WI
Well No. 3 - APO	
Farmor	5% ORRI
Farmee	50% WI

Taxes – Sharing Agreement

<u>Before Payout (BPO)</u>

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

<u>After Payout (APO)</u>

Proceeds of production taxed as income

IDC – costs to drill and complete a well that are not a part of the final operation of the well, other than depreciable assets; for example, survey work, ground clearing, drainage, wages, fuel, and repair.

The Basics - Recap

Farmout Agreement:

Assignment of WI, reserving ORRI, in exchange for drilling of test well

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Parties:

Farmor and Farmee

Purpose:

Lease preservation or salvage

Cost shifting

Expanding acreage

Exploration

Key Variations:

Conditions for Drilling Test Well

Convertible Overriding Royalty

Earned Interest Basis

Ongoing Issue:

Before Payout vs. After Payout

Payout Basis

Legacy Burden of Older Farmouts

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

Example 1: Mixed Convertible & Non-Convertible Overrides

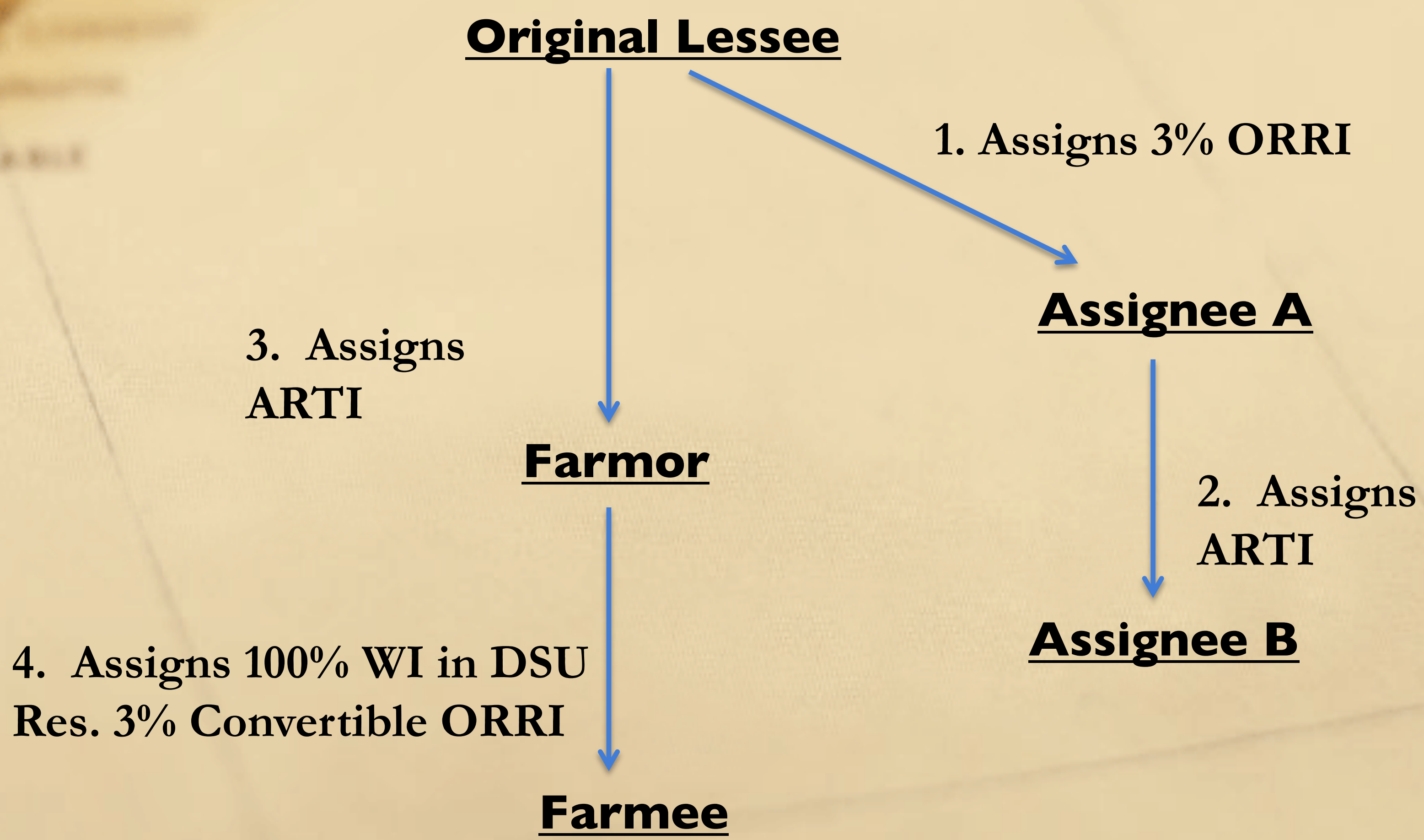
- The Farmout Scenario:
  - Farmor Owns 100% of WI at Time of Farmout
  - 100% WI Assigned in DSU Before Payout
  - 3% Override Reserved, Convertible to 50% WI After Payout

Example 1, Continued

- The BPO Ownership Picture:

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

Title Chain 1: The Intuitive Case



ARTI = All Right, Title, & Interest

Title Chain 2:
Looks Can Be Deceiving

Original Lessee

1. Assigns 50% WI Reserving PR 6% ORRI

Assignee A

2. Assigns ARTI

Farmor

3. Assigns ARTI

5. Assigns ½ of Farmor's RTI

4. Assigns 100% WI in DSU Res. 3% Convertible ORRI

Assignee B

Farmee

ARTI = All Right, Title, & Interest

Example 1: Impact on APO Owners

Title Chain 1

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

Title Chain 2

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

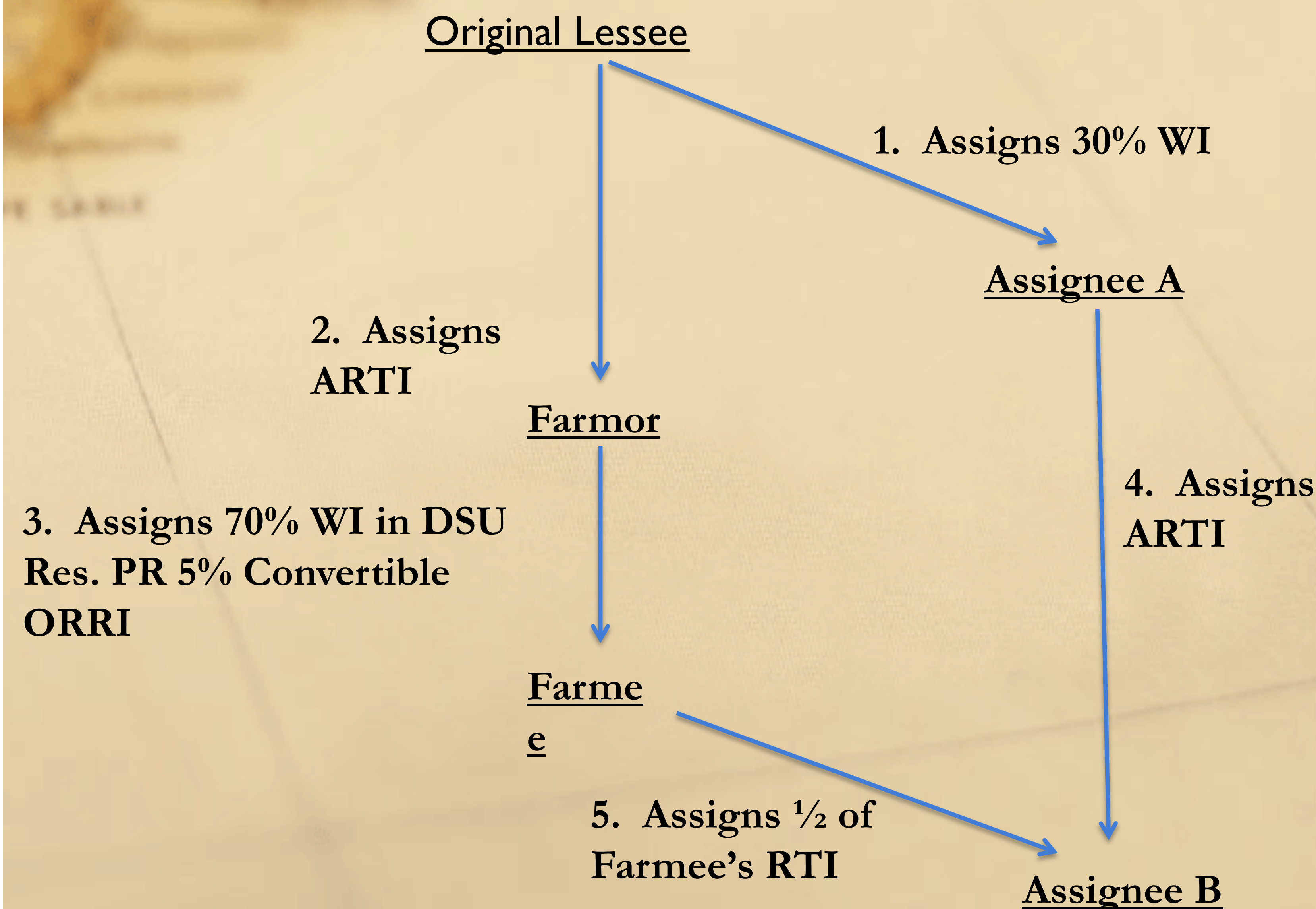
Example 2: Only Part of Working Interest Burdened By Convertible Override

- The Farmout Scenario:
  - Farmor Owns 70% WI at Time of Farmout
  - 70% WI Assigned in DSU Before Payout
  - Proportionately Reduced 5% Override Reserved, Convertible to ½ of Assigned WI After Payout

Example 2: The BPO Ownership Picture

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

Title Chain for Example 2



ARTI = All Right, Title, & Interest

Example 2: Determining Who to Reduce APO

- The Farmor Backs in to ½ of the Interest Assigned
  - Can't Simply Reduce Farmee's Interest
  - Track Farmed Out WI Through the Chain
  - Helpful to Think In Terms of Ratios:
    - 30/65ths of Assignee B's WI not subject to reduction
    - 35/65ths of Assignee B's WI will be reduced by ½ APO
    - Reducing Assignee B's total WI by ½ will not reach the right result

Example 2: The APO Ownership Calculation

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

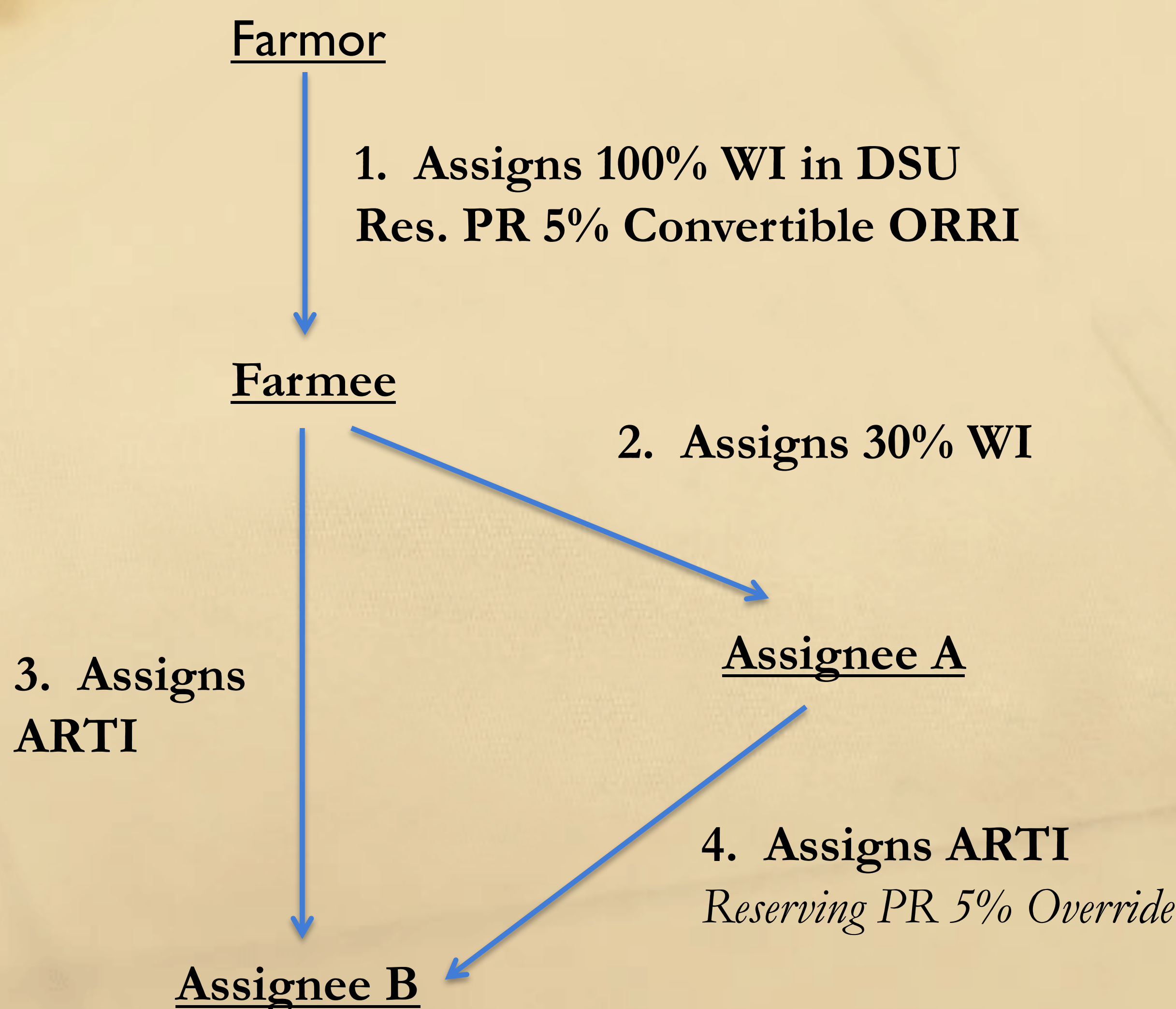
Example 3: APO Reduction of Non-Convertible Overrides

- The Farmout Scenario:
  - Farmor Owns 100% WI at Time of Farmout
  - 100% WI Assigned in DSU Before Payout
  - Proportionately Reduced 5% Override Reserved, Convertible to ½ of Assigned WI After Payout

Example 3: The BPO Ownership Picture

Owner	% Interest	Interest Type
Landowner	12.5%	Landowner Royalty
Assignee A	1.5% (5% x 30%WI)	Override
Assignee B	100% 81% (30%WI x 77.5%NRI) +(70%WI x 82.5% NRI)	Working Interest Net Revenue
Farmor	5%	Override
Farmee	0% 0%	Working Interest Net Revenue Interest

Title Chain for Example 3



Example 3: Look for Ancillary Impacts From Conversion

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

Troubles with Non-Recording

- Recording statutes generally provide protection to purchaser without notice (C.R.S. 38-35-109)
  - "No such unrecorded instrument or document shall be valid against any person with any kinds of rights in or to such real property who first records … except… those having notice thereof prior to acquisition of such rights"
- "Shelter Rule" provides protection to those purchasing from a protected purchaser (Strekal v. Espe, 114 P.3d 67 (Colo. App. 2004)

When are parties on notice?

- Actual notice?
- A recorded farmout?
- When an assignment specifies key terms and references the farmout?
- When an assignment only references a farmout?
  - In some states, may have duty to inquire
  - In Colorado, inquiry notice limited by statute (C.R.S. 38-35-108: Recitation of unrecorded instrument "shall bind only the parties thereto")

2 Main Takeaways

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

Questions & Comments?

Tjornehoj & Hack, LLC

Jon Tjornehoj, Managing Partner
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