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DOCUMENTING THE FARMOUT AGREEMENT

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I.
Introduction

1.01 **Managing Exploration Risk**. The business of exploring for oil and gas is unquestionably one of the most exciting businesses around. Many factors contribute to this excitement, but perhaps the greatest single factor is that the oil and gas explorationist's main competition is mother nature. From the origination of the prospect idea, to the drilling of the initial well to test the idea, geologists, geophysicists and engineers pool their collective talents in an effort to "outsmart" mother nature and get her to share some of the energy resources that we need to sustain our world economy. Although technological advances have helped improve our industry's drilling success rate, the exploration business remains an always challenging and sometimes cruel business that is not for the faint of heart.

Most E&P companies attempt to manage this "exploration risk" in two ways. First, the companies hire the most talented people they can find and equip them with the most advanced exploration tools they can afford. Without a doubt, the most important ingredient for success in the E&P business is having a creative group of "exploration minded" people that work together as a team to generate exploration opportunities. The second method E&P companies use to deal with exploration risk is to establish an exploration venture and share the risk with one or more other parties. This paper will focus on one such exploration venture, the farmout.

1.02 **Types of Exploration Ventures**. The term "exploration venture" means different things to different people. When I use this term, I intend for it to include any association or common enterprise between two or more persons that is formed for the joint exploration and development of lands that are believed to be prospective for oil and gas. An exploration venture may take the form of a separate legal entity (the "Project Entity") that is created for the sole purpose of conducting the joint exploration and development activities. Under this structure, the newly formed Project Entity (*e.g.* General Partnership, Limited Partnership or Limited Liability Company) owns the venture's assets and the participants in the venture own an equity interest in the Project Entity. Since this ownership structure can impose higher standards of conduct on the participants and significantly limit a participant's ability to assign, pledge or otherwise dispose of its interest in the venture, its use is usually limited to those situations where special tax considerations (*e.g.* special allocations of deductions or credits; avoiding the tax consequences of Rev. Rule 77-176) or participant considerations (multiple individual investors) dictate that a separate legal entity be created.

An exploration venture may also take the form of a common enterprise that is bound together by contractual commitments (collectively, the "E&P Agreement"), but is not a separate legal entity. Under the E&P Agreement structure, the ownership of, or the right to acquire an ownership interest in, the venture's assets is vested directly in each participant and the respective rights and obligations of the participants with respect to the joint exploration and development of the venture's assets is set forth in the E&P Agreement. The most common forms of E&P Agreement are the Exploration Agreement, the Participation Agreement and the Farmout

Agreement. When I use the term "**Exploration Agreement**", I am referring to a joint exploration and development contract that covers a large amount of acreage that requires a significant amount of exploration activity (*e.g.* 3-D or 2-D seismic survey, magnetic survey and/or geochemical survey) before the participants can identify prospects and drill wells on the acreage. The term "**Participation Agreement**" refers to a joint exploration and development contract that covers one or more defined prospects that are "drill bit ready" (*i.e.* no significant exploration activity is required before the initial test well is drilled). The term "**Farmout Agreement**" refers to a contract by which one party (the farmor) agrees to assign all or a portion of its oil and gas rights in certain acreage to another party (the farmee) in exchange for the performance of certain obligations (usually including the drilling of one or more wells) by the farmee. However, as some of the more recent transactions in the Haynesville Shale, the Marcellus Shale and the Fayetteville Shale have shown, categorizing a particular E&P Agreement as either a Participation Agreement or a Farmout Agreement can be difficult when various financial, operational or land considerations require a hybrid approach to documenting the exploration venture.

1.03 **Goals of the Documentation Process**. Regardless of which structure is used for an exploration venture, the goals of the documentation process are the same:

1. To accurately reflect the business deal;

2. To clearly identify and effectively manage risks; and

3. To create an understandable and legally enforceable document.

The remainder of this paper will address the key issues that should be considered in negotiating and drafting a Farmout Agreement.

II.
Getting the Business Deal Right

2.01 **The Term Sheet/Letter of Intent**. The first goal of the documentation process is to ensure that the Farmout Agreement accurately reflects the "business deal" between the parties. One of the most effective ways to achieve this goal is to set out all of the material trade terms in a term sheet or letter of intent and have all of the parties agree to such terms before drafting the definitive Farmout Agreement. In addition to facilitating the review and approval of the trade by management, the term sheet/letter of intent can be used as a "business terms" checklist for the draftsman of the Farmout Agreement.

2.02 **Avoiding the "Unintended Contract"**. Another advantage of using a term sheet/letter of intent is that it can eliminate the problem of the "unintended contract". The only thing worse than having a business deal fall through because the parties cannot agree on the contract terms, is having a dispute with the other party over whether a contract exists or not. The legal analysis of contract formation is relatively straight forward (Has there been an offer? If so, has the offer been accepted?). However, the line between "preliminary negotiations" and "offer

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