FARMOUTS IN AN ERA OF LOW OIL PRICES

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TOPICS

- Basic Oil and Gas Farmouts
- Tax Partnerships
- Alternative Asset Financing Transactions

Farmout Agreements – The Basics

Common Objectives

- The Farmor (typically a working interest owner) seeks additional funds to develop one or more wells
  - Traditional financing may not be available
  - Doesn't want to bear 100% of risk and cost of drilling
  - Wants to bring in a co-investor in a tax efficient manner

- The Farmee wants to earn a working interest in the well/lease
  - Has a favorable view of the oil/gas play
  - Has available capital to invest

Legal Documentation

- Farmout Agreement
  - Specifies applicable lease or leases to be developed and whether one or multiple wells will be developed
  - Contains details regarding Farmee's financial commitment for earning an interest in the subject asset(s) (i.e., 100% or partial carry)
  - Specifies the parties' post-development interest in the subject asset(s)
    - Payout provision?
    - Convertible overriding royalty retained by Farmor during payout?
    - Farmee's permanent interest
  - Details the parties' agreed tax treatment
    - Elect-out of Subchapter K?
    - Tax partnership?
- Joint Operating Agreement
- Tax Partnership Agreement?

Standard Farmout Example

- Facts:
  - Farmor, the working interest owner of a <u>single</u> mineral property (Blackacre), agrees to assign a 50% undivided interest in Blackacre to Farmee in consideration for Farmee's agreement to fund 100% of the costs to drill a well on Blackacre
  - Farmee is entitled to 100% of proceeds until it has recouped all of its costs in drilling, equipping and operating the well; thereafter, Farmee is entitled to a 50% interest in Blackacre
  - Parties elect out of subchapter K