Round 2

Written by Christopher Kulander[1]

GENERAL FACTS

The Companies

Dorfner Petroleum, Inc. ("***Dorfner***") is an oil and gas company based in Brownfield, Texas. In the past, Dorfner has had success following other companies into established plays in West Texas and southeastern New Mexico. When there, it engages in one of two practices: buying oil and gas leases from the first wave of companies shortly before those leases expire; or entering into "participation" or "farmout" agreements, whereby Dorfner can "earn" a full or partial assignment of a coveted lease by first engaging in operations on the leasehold. Such operations typically involve drilling a well or conducting geological and geophysical surveying.

Dorfner is a relatively recent arrival on the Permian Basin scene. The company was started by several engineers who all previously worked for local operators, along with a lawyer who previously worked for a law firm. The current president of Dorfner is Leon Curtis, a respected lawyer from Odessa, Texas, and a South Texas College of Law Houston alumnus.

Montgomery Oil and Gas, Inc. ("***Montgomery***"), is an oil and gas company with its corporate headquarters in downtown Midland, Texas, in the iconic Wilco Building. Montgomery is a large local operator, well known in West Texas for its innovative program of developing formations that no one had previously thought were economic. Montgomery's principals include several engineers, geologists, lawyers, and landmen who left Pioneer Natural Resources, Concho Resources, and Optima Land Services to pool their assets and knowledge. The current president of Montgomery is Peggy Strickling, daughter of the founder and a former landman.

Full or partial lease assignments commonly occur in the context of a farmout agreement. Under a traditional farmout, an oil company that has a lease covering a large area may transfer its interest in specified acreage to an operator that agrees to drill a well to a specified depth and at a specified location on the acreage transferred. Such drilling will probably enable the transferor to maintain its lease[2] on the rest of the acreage without incurring any out-of-pocket drilling costs and also provide it with valuable survey

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[2] Most leases are split into two terms: primary and secondary. Often, the lessee must commence drilling or achieve production during the primary term to maintain or "hold" the lease.

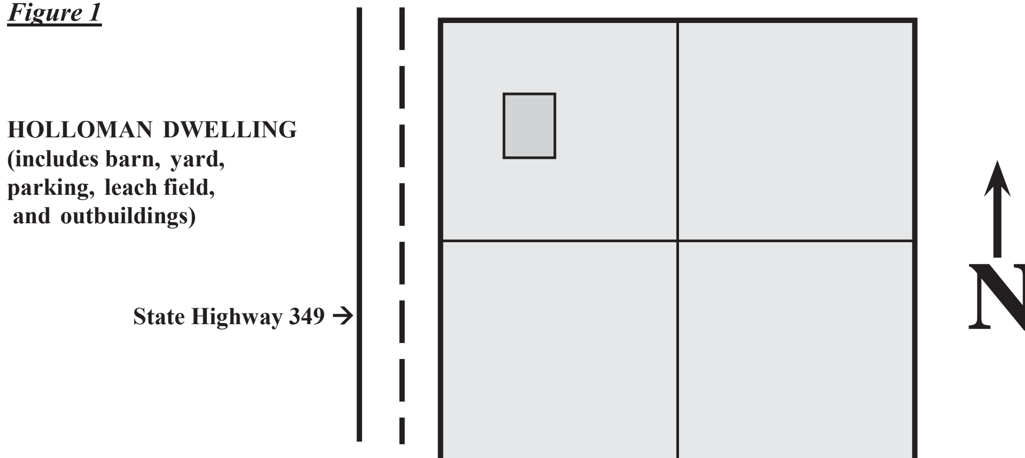
information concerning the desirability of drilling on the retained acreage.

The Location

The Wolfcamp formation is a hydrocarbon-rich shale formation found throughout the Permian Basin in West Texas, designated by the Texas Railroad Commission (the "***RRC***") to consist of the Wolfcamp "A" and Wolfcamp "B" shale zones. The U.S. Geological Survey has estimated that the Wolfcamp shale contains 20 billion barrels of oil, 16 trillion cubic feet of natural gas, and almost 2 billion barrels of natural gas liquids. Like some other formations in the Permian, the recovery costs for the Wolfcamp Shale are low enough to keep exploration and production activities economic, even in times of relatively low hydrocarbon prices.

The 2,560-acre leased tract in question is in Upton County, Texas. The captioned lease is four square miles in size and consists of four 640-acre square sections of land, all owned in fee (surface and minerals) by the Scott I. Holloman Family Trust ***(see Figure 1)***. Montgomery owns leases covering 100 percent of the tract's minerals. None of the terms in the leases restrict Montgomery from either assigning the leases or assigning out a beneficial interest in the leases through a farmout agreement. Each lease provides for a lessor's royalty[3] of one-fifth (20 percent) for the Holloman Trust, and no other royalty interests (including overriding royalties[4]) burden the captioned leases. The captioned leases are in their primary term, have no producing wells on them, and are not pooled[5] with any neighboring leases. The only public road adjacent to the captioned acreage is Texas State Highway 349, a two-lane state highway that runs north to south, west of the captioned acreage. There is one permanent family dwelling on the northwest quadrant.

<u>Figure 1</u>



[3] A "lessor's royalty" is a percentage share of the value derived from production, which is granted to the lessor in the oil and gas lease, and which is free of the costs of drilling and producing.
[4] An "overriding royalty" is a percentage share of production, or the value derived from production, which is free of all costs of drilling and producing, and is held by the lessee or working interest owner (in this case, it would be Montgomery).
[5] "Pooling" refers to an agreement by parties to consider various tracts of land, sometimes not even contiguous tracts, as one unit, where achieving production on one results in holding the lease on both tracts. The practical effect here is that there is no production elsewhere that is holding Montgomery's leases.

The RRC's "field rules[6]" for the Wolfcamp Shale, including the Wolfcamp "A" and "B" zone, allow an operator a spacing unit of 40 acres per well. However, the RRC may allow for larger spacing units. How much larger is partly impacted by the terms of leases and various farmout agreements between parties. Another factor is the existence of special field rules that may allow for spacing units of 80 acres or more. For example, there are "old" field rules in existence in parts of Upton County that allow units as large as 160 acres.

The Plan

Dorfner wanted to acquire some working interest[7] in the Wolfcamp "A" and "B" zones. To this end, it set out to acquire leases, either by taking its own leases in unleased areas, buying leases, or entering into arrangements with existing lessees. Unfortunately for Dorfner, most of the prime acreage it desired to lease was already leased. In addition, while it managed to buy assignments of several leases, it did not get into the best acreage positions. This left Dorfner with the option of entering into a farmout agreement with existing lease owners. Finding that Montgomery owned leases in the area where Dorfner had interest, Dorfner approached Montgomery with the idea of acquiring acreage through a farmout.

Montgomery responded enthusiastically to the idea. It had more prospective leased acreage in the Wolfcamp formation than it could drill in the next couple of years, given current prices, and Peggy Stickling—the principal corporate officer at Montgomery—saw Dorfner's offer as a good opportunity to unload some acreage as well as recoup some benefits for itself in the process. One worry for Montgomery is that it has not worked with Dorfner before, and in typical farmout agreements—unlike assignments—the party with the acreage relies on the party seeking the acreage to follow through with activities that retain the lease(s) covered by the farmout agreement.

Farmout Agreements—Generally

A farmout is an agreement under which one who owns an oil and gas lease (the "***farmor***") assigns an interest in it to another person (the "***farmee***") in exchange for testing and drilling operations. The parties may enter into such an arrangement for many reasons. The farmor may use the agreement to maintain the lease by securing production before the expiration of the lease's primary term or to comply with offset drilling or development covenants; it may wish to acquire geological information that will enable it to assess the productive potential of retained acreage or simply to obtain an interest in production without costs. The farmee may view the farmout as a way to acquire leased acreage not otherwise available or at lower cost than would otherwise be possible. The farmout may be used as a mechanism for sharing the risk of drilling an expensive or high-risk well.

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[6] "Field rules" are regulations that dictate the creation of wells in a given area. There are often baseline field rules set by the state, but there may also be additional field rules for a specific area. Examples include where wells may be drilled, allowing one well per minimum amount of acreage, a.k.a. a spacing unit (like 1 well per 40 acres of land), or a minimum distance between a well and other objects, like fences or lease lines.

[7] A party with a working interest pays for all or a portion of production but generally receives all or a commensurate amount of the proceeds of a well, e.g. 100% or 50% if it covered 50% of production costs. Compare that to a party who merely holds a royalty interest. While the party often does not participate in or pay for production, their percentage of the profits is often lower, e.g. 3%.

The drilling provision in the farmout agreement may give the farmee the option to drill a well or it may be a firm obligation. Either way, a farmee who complies with its terms is entitled to the assignment specified in the agreement. This assignment may constitute all of the acreage comprising the leasehold estate owned by the farmor or only a portion of the acreage. The most common assignment resulting from a farmout has traditionally been the entire working interest in the drilling spacing unit, subject to an overriding royalty in the farmor. This reserved overriding royalty may be further convertible into a working interest for the farmor when the well pays out. This is sometimes called a "back-in" provision. This allows the farmor to "exchange" its royalty interest for a fraction of ownership of the working interest.

Occasionally, farmout agreements require one party to undertake some sort of seismic testing. Far more commonly, the agreement requires drilling a test ("initial") well or wells.[8] The agreement must make clear exactly what is required for the farmee to earn an interest. The most common agreement for vertical wells contains a "produce-to-earn" provision under which the farmee is entitled to an assignment only by completing a well capable of producing in paying quantities. Under a "drill-to-earn" agreement, the farmee earns its interest merely by drilling to a required depth.

The Montgomery/Dorfner Farmout—Terms

After significant discussion among the business principals, Montgomery and Dorfner have decided to see whether "legal" can come to an agreement about farming out some acreage from Montgomery, as farmor, to Dorfner, as farmee. The plan for when the lawyers get together in Houston is to negotiate the most important particulars of a potential farmout agreement and then, if an agreement is reached, to draft the document later. In addition, if this round of negotiations goes well, the result may serve as a template for future farmout agreements on other leased acreage all over the Permian Basin.

Six general points of the deal loom largest, though other points may come up in negotiations:

First, how many acres will be covered by the farmout agreement? If the entire block of captioned acreage is not covered under the terms of the farmout agreement, which specific areas will be covered and which will not?

Second, will the farmout agreement include an obligation or an option for the farmee to drill wells? If the farmout is an "obligation" agreement, how many wells will the farmee be required to drill? Will it be just the "initial" or "test" well, or will subsequent wells need to be drilled? In addition, if it is an "obligation" agreement, and a required well is *not* drilled, to what kind of liquidated damages may the farmor be entitled?

Third, will the farmout agreement be a "drill-to-earn" or "produce-to-earn" deal? With a "drill-to-earn" farmout agreement, the farmee can earn the prescribed assignment by merely drilling a dry hole so long as the prescribed depth is reached and, if necessary, tested. On the other hand, with a "produce-to-earn" agreement, the farmee must drill a well capable of producing in paying quantities to earn the prescribed assignment.

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[8] Such requirements are rarely free of ambiguity or other uncertainties. For example, a provision that the farmee will drill a test well at a location that is "mutually acceptable" to both parties is unenforceable, because the parties have merely agreed to agree to a material term at some time in the future. *See, e.g.,* Aurora Petroleum, Inc., v. Cholla Petroleum, Inc., 2011 WL 652843 (Tex. App. 2011)

Fourth, if there is a drilling obligation(s), how large a spacing unit (in acres) will the farmee earn upon successful completion of its (each) drilling obligation?

Fifth, what kind of consideration will Montgomery receive in return for farming out the acreage to Dorfner? Montgomery will probably want some money upfront for entering the agreement, similar to the bonus check a lessor receives for entering an oil and gas lease, and some kind of production-based payment, like an overriding royalty on each well. Other consideration is possible.

Sixth, will Montgomery have a “back-in” option on each drilled well to take some or all of any overriding royalty it earns and convert it into a working interest in said well? If so, how much working interest will Montgomery get?

CONFIDENTIAL FACTS FOR MONTGOMERY

While Montgomery is happy that it owns significant leasehold working interests in the Wolfcamp Shale play, it is concerned that a significant percentage of that acreage is composed of leases that are approaching expiration of their primary terms. Due to languishing hydrocarbon prices, Montgomery has had to curtail its drilling program and does not have enough money to drill the wells necessary to maintain the leasehold positions it owns. Rather than let the leases it cannot drill expire, Montgomery is interested in farming out the acreage it cannot drill upon. However, Montgomery is not interested in simply assigning away its Wolfcamp leases but rather would like to maintain positions throughout the Wolfcamp Shale. This is because the recovery costs in the Wolfcamp are low enough that it can participate in wells that are still economic at low prices.

When Dorfner approached Montgomery about acquiring one or more lease assignments, Montgomery was interested. When Montgomery countered that it was only interested in farming out acreage, Dorfner agreed to the idea in principle, subject to what it deemed "successful negotiation of terms." Montgomery's principal, Peggy Strickling, then delivered to her lawyers the terms she would like to govern the discussion.

First, Peggy Strickling would like to limit coverage of this first farmout agreement. Working relationships between companies are very important in West Texas because the same operators meet again and again. While she has heard good things about Dorfner, neither she nor anybody else at Montgomery has actually worked with the upstart company from Brownfield. Therefore, although 2,560 acres are available for farming out in the area that Dorfner desires, Strickling wants to farm out only half that acreage (1,280 acres is exactly half). This way, Montgomery can see firsthand what kind of company Dorfner is and whether it can get such operations done in a time of challenging commodity prices. Finally, Montgomery has a good relationship with the Holloman family, which lives in the dwelling on the northwest quadrant of the captioned land, and would like to avoid leasing that tract unless a premium is paid.

Second, Montgomery would like Dorfner to be obligated to drill at least one test well and one subsequent well into the Wolfcamp formation. At a minimum, Strickling wants Dorfner to complete two wells, but the more wells it is obligated to complete the better. Since the expiration date of the leased acreage is approaching fast, if Dorfner does not complete the wells as promised, there probably will not be time to farm the acreage out to someone else. Therefore, Montgomery wants to include a liquidated damages clause in the farmout that requires Dorfner to pay at least $500,000 for each "obligation" well not drilled.

Third, with regard to when the lease assignment is earned, Montgomery would ideally like a "produce-to-earn" agreement. So, an assignment of acreage would only take place only if production in paying quantities is achieved. However, Peggy Strickling is willing to give ground on this point and settle for a "drill-to-earn" earning scheme instead of a "produce-to-earn" provision if Montgomery is entitled to a copy of all well data from each well drilled and, as she hopes, if Dorfner gives ground on some other points.

Fourth, Montgomery wants to limit the amount of acreage earned by Dorfner for each well drilled or completed to just the minimum spacing unit required around the well per the field requirements of the RRC under Statewide Rule 40(d). For a well in the Wolfcamp Shale, this is 40 acres but could technically be more. Peggy Strickling does not

want to agree to assigning units of acreage greater than 80.

Fifth, as upfront consideration for entering any farmout agreement, Montgomery's businesspeople want a payment of at least $1,000 per acre covered by the agreement, if not more. Montgomery's personnel have not worked with Dorfner before, and Montgomery would like some recompense if Dorfner fails to drill and the captioned leases expire. In addition, Peggy Strickling knows that if production is achieved, the real avenue of revenue is in royalty, and she would like at least a 3 percent overriding royalty on each well. In other words, if Dorfner achieves production from a well on the acreage it is attempting to earn through the agreement, Montgomery wants at least 3 percent of every dollar of revenue.

Sixth, Montgomery does indeed want a "back-in" option so that it can convert its overriding royalty into a working interest in the well/acreage constituting each spacing unit once the well on that spacing unit achieves payout. Peggy Strickling wants the option for Montgomery to convert the overriding royalty into at least a one-third (1/5) working interest.

CONFIDENTIAL FACTS FOR DORFNER

Dorfner wants to get into the Wolfcamp Shale play as an operator with its own working interests. President Leon Curtis knows that Montgomery has promising acreage in Upton County, and since Montgomery is not willing to merely assign the leases, he wants Dorfner to attempt to negotiate farmout agreements with Montgomery.

First, Leon Curtis would like to get as much of the available acreage covered under the farmout agreement. Working relationships between companies are very important in West Texas because the same operators meet again and again. The Dorfner principals have heard good things about Montgomery and look forward to working with them. If Dorfner cannot lease all of the captioned land, it would like, at a minimum, to lease land with direct access to State Highway 349.

Second, Dorfner would like the option to drill. It does not want to be obligated to drill. At most, Dorfner will accede to being obligated to complete four wells in the Wolfcamp (the "initial" or "test" well and three subsequent wells). Wells are expensive, as Curtis's engineers know, and being obligated to drill wells after the initial well shows the area to be in a difficult location is a potential waste of money, even though the Wolfcamp Shale is very promising overall. Curtis is willing to pay some liquidated damages if the leases expire and obligation wells have not been drilled. Therefore, Dorfner is willing to include a liquidated damages clause in the farmout that requires Dorfner to pay, at the most, $750,000 per "obligation" well not drilled by lease expiration.

Third, with regard to the timing of when the lease assignment is earned, Curtis is demanding a drill-to-earn arrangement. If it's necessary to make a deal, Dorfner is willing to deliver to Montgomery copies of all well data from each well drilled provided Montgomery executes a nondisclosure agreement.

Fourth, Dorfner wants to earn as much acreage as possible with each assignment it receives for drilling (or, if need be, drilling and producing from) a well. Therefore, while Dorfner will accept just the minimum spacing unit as required by the RRC under Statewide Rule 40(d)—40 acres in the Wolfcamp in Upton County—Leon wants to negotiate for however much more the RRC will allow per spacing unit over that, which maybe 80 or even 120 acres.

Fifth, Dorfner's businesspeople realize that Montgomery will probably want, as upfront consideration for entering any farmout agreement, some kind of cash payment. Curtis doesn't want to pay any more than $2,000 an acre and of course would like to pay *significantly* less. In addition, Curtis knows that, if production is achieved, the real avenue of revenue is in royalty, and he expects that Montgomery will want an assignment of overriding royalty on any production from the captioned acreage/well. Curtis would like the overriding royalty assigned Montgomery to be as small as possible but no larger than 4 percent r on a given well. Furthermore, the total royalty on whatever number of wells is agreed to cannot exceed 15 percent.

Sixth, and related to the fifth point, Curtis and the businesspeople at Dorfner expect that Montgomery will want a "back-in" option so that it can convert its overriding royalty into a working interest in the acreage comprising each spacing unit once a well on that spacing unit achieves payout. Dorfner accepts this but does not want the Montgomery overriding royalty interest to convert into a working interest any larger than three-fifths (3/5).

JUDGE SHEET

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Deal Points	**Montgomery**	**Dorfner**
(1) Acreage amount under farmout:	1,280 acres	as much as possible
(2) Drilling requirement/liquidated damages:		
a. Option or obligation to drill	Wants obligation to drill 2 wells (1 test and 1 subsequent).	Wants option to drill. Will accept obligation up to 4 wells (1 test and 3 subsequent).
b. $ obligation per well not drilled	at least $500,000	$750,000 or less
(3) Drill-to-earn or produce-to-earn:	wants produce-to-earn but can do drill-to-earn if provided seismic data for each drilled well.	wants drill-to-earn and willing to provide seismic data on each drilled well if NDA agreed to.
(4) Earned acreage spacing unit size:	40 acres/well preferred but can agree to a max of 80 acres.	as much as possible/ largest approved unit
(5) Consideration for Montgomery:		
a. Cash payment at signing	at least $1,000/acre	$2,000/acre or less
b. Overriding royalty	at least 3%	4% or less per well. Total royalty cap of 15%.
(6) Back-in working interest assignment:	at least 1/5 working interest	at most 3/5 working interest