by Anna Nerush

One of the key features of a farmout agreement that distinguishes it from other forms of sale and purchase agreement is the consideration that is agreed for the transfer of an interest. In understanding how a particular consideration structure is agreed upon in a farmout agreement it is necessary to appreciate that the agreed consideration may comprise a number of different components which reflect:

(i) the recovery of costs already expended on a concession;
(ii) the deflection of costs that will need to be incurred in the future under the concession; and
(iii) a pure profit element generated from the transfer of an interest in the concession.

These different elements may be identified separately in the farmout agreement but are more often subsumed in the overall consideration amount and structure included in the farmout agreement.

The amount of the consideration payable under a farmout agreement will reflect the level of uncertainty of outcome which exists in respect of the interest to be farmed out, market conditions, the farmor's desire to divest the interest and the farmee's desire to acquire the interest. An under-appraised concession will generally result in a lower overall amount of consideration being payable, and a

[3] AIPN International Model Farmout Agreement, 2019, available at *http://www.aipn.org* [accessed 12 September 2019].

reduced level of uncertainty of outcome relating to a concession interest (through a greater level of appraisal of that interest) should result in a higher overall amount of consideration being paid as a condition of admission to the concession. Where
14–21 part of the consideration payable by a farmee under a farmout agreement represents a pure profit element, that part of the consideration is commonly described as the "promote". The promote represents the ratio between the proportion of the expenditure that the farmee will assume and the proportion of the interest that it will earn as a result of the farmout. Where a farmee incurs 100 per cent of the expenditure and earns 100 per cent of the intended interest, this is called a "ground floor" promote, where a farmee incurs 100 per cent of the expenditure and earns 50 per cent of the intended interest, this is called a "2 for 1" promote, and so on.

Promote level	**Farmee pays (% of defined costs)**	**Farmee receives (% of concession interest)**
3:1	100%	33.3%
2:1	100%	50%
1:1 (ground floor)	100%	100%
1:2	50%	100%
1:3	33.3%	100%

Under a farmout agreement the nature of the consideration payable by a farmee is usually closely linked to the supervening obligations and costs that have been assumed by the farmor under the concession.

WORK OBLIGATIONS

There is often a cash payment in modern farmouts, however, it is the Work
14–22 Obligation that makes a farmout agreement uniquely different from a standard purchase agreement. A Work Obligation, instead of or in addition to a cash payment, may create a substantial tax benefit for the parties by having a payment linked to deductible project operations costs as opposed to a straight cash payment.

In addition to farmee's obligation to pay the cash element of the consideration, past costs and/or carry farmee will often commit to "perform" certain work. Where Work Obligations form part of the consideration, the parties need to consider the following issues.

(i) *Scope of Work Obligations*—typically, the work obligation will be defined by reference to the underlying minimum work commitments originally assumed by the farmor to the host government, as described in the concession. Such work may relate to seismic or well commitments and in any case as this will be expressed as work to be performed before the transfer of the participating interest to the farmee can be effected, it is critical to ensure that the farmout agreement sets out full and accurate technical scope of such works.

(ii) *Performance or payment*—Work Obligations may be expressed as a performance obligation, however in practice, this may represent a payment obligation as it is customary and typically required by law and local regulations for the Operator to continue performing the work and farmee only funds the costs for the Work Obligation. Where physical work is to be carried out by the farmee, the farmor will be concerned to ensure such work is carried out to the standard required under the concession agreement and that any failure to perform does not jeopardise the farmor's right to and under the concession agreement. The farmor will often also seek cash payment for unfulfilled work to enable it to perform or sub-contract performance of unfulfilled obligations.

(iii) *Monetary caps*—whether the amount of expenditure that farmee must incur in performing (or procuring the performance of) the work obligation should be capped and thus the work obligation will be deemed to have been fulfilled once the cap is reached.

(iv) *Partial performance/failure to perform*—the work obligation formulation creates a significant potential for dispute between the parties as to whether the work obligation has been fully performed and whether such partial performance amounts to a breach by the farmee of its obligations under the farmout agreement and whether such breach should result in the loss by the farmee of any entitlement it may otherwise have had to the interest to be transferred.

English law creates a distinction between "entire obligations" and "divisible obligations". If a work obligation is drafted as an entire obligation, then the farmee is required to fully perform (or procure performance of) the work obligation before it is entitled to require counter-performance from the farmor (through the transfer of the intended interest). By contrast, if the work obligation is drafted as a divisible obligation, where the overall performance by the farmee is separable into different elements and attributed to different parts of the farmout agreement, performance can then be measured by reference to the farmee's performance of the individual contract parts, as distinct obligations. This is similar to the difference between a lump sum contract (which creates an entire obligation) and a milestone-based contract (which creates divisible obligations).

Where only part of an entire obligation has been performed, then English law provides that the farmee can recover nothing[4]: neither the transfer of the interest defined in the farmout agreement, nor a reduced interest proportionate to the extent of the work done. The construction of a work obligation as entire will therefore operate to the advantage of a farmor and

[4] *Cutter v Powell* (1795) 6 Term Rep. 320; 101 E.R. 573; and *Appleby v Myers* [1867] L.R. 2 C.P. 651. Note however, that an exception to this principle is the doctrine of substantial performance which, although widely criticised by a number of academics, could result in a farmee being entitled to the interest defined in the farmout agreement provided that it has substantially performed (albeit not completed) its work obligation and subject to admitting a counterclaim from the farmor for damages in respect of the uncompleted elements of the obligation.

the disadvantage of a farmee. The farmee will receive no interest in the concession, notwithstanding that it may have expended considerable time, effort and money in performing (or procuring performance of) a large part of its obligations under the farmout agreement.

By contrast, where only part of the work obligation under a farmout agreement has been performed by or on behalf of a farmee and that work obligation has been structured on a divisible basis, partial performance of the work obligation will entitle the farmee to earn a proportionate share of the interest to be transferred. This is a considerably better position for the farmee. However it may have limited appeal to a farmor who is then exposed to the risk that a failure to complete or perform the work obligations could jeopardise the continuing security of the underlying concession. Where the performance of the work obligation under a farmout agreement is intended to satisfy the performance of one or more of the minimum work commitments under the relevant concession, the parties will need to find an alternative means by which the concession obligations can be met.

Given the potential legal uncertainty associated with the interpretation of a work obligation as an entire obligation, the parties may prefer to include a right to substitute the work obligation with an alternative performance obligation. This right is particularly valuable to a farmee where it becomes impossible for the farmee to perform (or procure performance of) the primary set of work obligations through circumstances out of its control. The alternative performance obligation could include the drilling of a substitute well or the payment of a defined cash amount by the farmee in lieu of physical performance. In each case, the parties will need to define clearly the circumstances in which alternative performance will be permitted. Under the CAPL Farmout & Royalty Procedure a substitution right in respect of the drilling of a well is only permitted where the farmee encounters "mechanical difficulties or a substantially impenetrable formation … that, in its reasonable opinion, make further drilling of the … Well commercially impracticable".[5] While this description attempts to establish some parameters by which the parties can decide whether the farmee has the right to invoke the alternative performance provisions under the farmout agreement, it remains subjective in a number of respects. This could lead to dispute between the parties as to what constitutes a "substantially impenetrable formation" which is "commercially impracticable".

(v) *Weighted interest*—a Work Obligation and the interest earned by a farmee may also be structured on a weighted basis. For example, where the work obligation requires the drilling of multiple wells, the drilling of the first well may earn the farmee only a relatively small interest, with the farmee earning a larger interest each time another well is drilled. The size of interest earned by the farmee at each stage may even be weighted towards the later wells. For the farmor, the value of this approach is that it provides

[5] Subclause 3.02A of the Farmout & Royalty Procedure, 2015, Canadian Association of Petroleum Landmen.

an incentive for the farmee to perform (or ensure the performance of) all of its work obligations under the farmout agreement, and not just those in the early stages.

MONETARY CONSIDERATION

The parties may prefer the consideration under the farmout agreement to be structured as a payment obligation. This may be driven by a range of different factors such as farmor concerns about ensuring proper performance by the farmee (as described above), regulatory restrictions which prevent the farmee from undertaking (or procuring the performance of) the works or commercial drivers such as the farmor's desire to receive all or part of the consideration for the transfer of the interest in cash or a cash equivalent. **14–23**

This could be a simple cash-based structure with or without elements of deferred or contingent consideration. However, there are also a number of monetary based consideration structures which are unique to the farmout agreement. These are considered below.

CARRIED INTERESTS

A carry is not unique to farmouts and is a common element of joint operating agreements involving a national oil company (NOC) where the contractor entities fund the NOC's share of joint operating costs during the exploration period. In the context of a farmout, under a carry arrangement, a farmee agrees to pay a farmor's share the costs associated with the performance of certain joint operations. The carry structure ensures that the consideration payable by the farmee is directly related to, and directly expended on, the costs which will necessarily be incurred to perform the joint operations. This could include the costs associated with conducting seismic or other survey work or of drilling exploration wells or further appraisal works. **14–24**

There are several key factors to be considered by both farmor and farmee when negotiating a carry arrangement:

(i) *Definition of the carried costs*—farmee's payment obligations will be tied to specific agreed works, therefore the works which are intended to fall within the scope of a carry arrangement must be defined clearly and will often be linked back to an approved work programme and budget.
(ii) *Monetary caps*—a farmee will typically seek to quantify and cap the carry to limit its exposure. Once the agreed threshold is reached the farmee's obligation to fund farmor's share of costs will end.
(iii) *Entitlement to any unspent carry*—whether the farmor is entitled to receive any unspent carry amounts or whether such amounts should be for the benefit of the farmee.
(iv) *Hard or soft carry*—whether or not all or part of the carried costs paid by a farmee are later repayable from the proceeds of production sales by the farmor (soft carry).

Farmee may seek some form of collateral support in respect of the farmor's repayment obligations to mitigate its credit risk exposure.

(v) *Control*—whether farmor's rights to vote and influence joint operations and/or to access information relating to joint operations should be limited during the carry period, requiring it to consult and act in collaboration with the farmee or on its instructions.

(vi) *Assigning the benefit of the carry*—whether during the carry period, the farmor should have the right to transfer its participating interest to which the carry applies and thus the benefit of the carry.

(vii) *Cost recovery*—allocation of the carried costs between the parties for the purpose of cost recovery under the concession and whether these should be treated as costs associated with farmor's participating interest share of costs under the concession and therefore recoverable by it or by the farmee as the party paying the costs of performing the concession as a result of the carry arrangement.

(viii) *Recovery of past costs*—often the consideration payable under the farmout agreement will also include an element which recognises the pre- productive capital ("past costs") that has been expended by the farmor on the interest prior to entering into the farmout agreement. Having been verified by the farmee, past costs will often be capped and linked to specific activities, such as seismic and magnetic surveys and/or drilling of exploration wells.