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FARMOUT AGREEMENTS: NAVIGATING THE WILD WEST OF THE BANKRUPTCY WORLD

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While farmout agreements are commonplace in the oil & gas industry, the treatment of farmouts in bankruptcy is far from certain. A farmee can suffer disastrous consequences as a result of a farmor's bankruptcy. The following is a summary of the potential issues parties to farmout agreements may face if the farmor enters bankruptcy, as well as drafting considerations to try to avoid bankruptcy's harsh effects.

Are the leasehold interests dedicated under a farmout agreement part property of the bankruptcy estate?
The Bankruptcy Code provides for a carve out of interests transferred or agreed to be transferred pursuant to a farmout agreement. It is generally accepted that acreage drilled and earned pursuant to a farmout is excluded from a farmor-debtor's bankruptcy estate. However, it is still an open question as to whether the exclusion applies to undrilled acreage, which turns on whether the farmout conveyed a real property interest in the undrilled acreage to the farmee.

Are farmout agreements executory contracts that can be rejected in bankruptcy?
Debtor-farmors may attempt to shed a burdensome or uneconomic farmout agreement by rejecting it under section 365 of the Bankruptcy Code. If the farmout agreement is just a commercial agreement among parties with unperformed obligations on both sides, it may be rejected. If the rights under the farmout agreement (right to drill and develop acreage) are covenants running with the land or equitable servitudes under state law, the agreement cannot be rejected in bankruptcy.

Can a debtor sell its leasehold interests free and clear of a farmout agreement?
The Bankruptcy Code allows a debtor-farmor to sell its assets free and clear of interests that are in bona fide dispute, which means if there is a dispute between the farmee and the farmor over their relative rights in the farmout property, the bankruptcy court will likely allow the debtor-farmor to sell free and clear of the farmee's interest, cutting off the farmee's rights to the leasehold estate and resulting in the farmee's only recourse being the proceeds of sale.

The bottom line is that the farmee will likely be able to retain acreage drilled and earned prior to the farmor filing bankruptcy; however, it may lose the right to drill and earn any undeveloped acreage.

Potential farmees drafting a farmout agreement with an eye toward avoiding the unknowns of bankruptcy should consider the following:

1) Structure the agreement as a term assignment rather than a farmout. By taking an assignment of the underlying acreage up front, farmee/assignees are in a better position to argue that the assigned acreage is not property of the farmor/assignor's bankruptcy estate.

2) If the farmor is unwilling to agree to a term assignment, include granting language that makes clear that the farmor is conveying to the farmee its right to drill and develop (which is a recognized real property right under Texas law). Bankruptcy courts are generally unwilling to sell a non-debtor's property absent their consent.

Gray Reed's Energy and Restructuring practices have extensively litigated these issues in the Vanguard Natural Resources bankruptcy and are battle-tested, experienced and able to guide you through the wild frontier that is farmouts in bankruptcy. For more information, contact Jason Brookner (jbrookner@grayreed.com) or Philip Jordan (pjordan@grayreed.com).