

## AN OVERVIEW OF DRILLCO TRANSACTIONS AND SELECT DRAFTING CONSIDERATIONS

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## I. INTRODUCTION

In recent years, the term “DrillCo” or “DrillCo Transaction” has established itself in the lexicon of the oil and gas investment community to describe drilling joint ventures where a capital provider (“Investor”) and oil and gas exploration and production company (“E&P Company”) enter into an agreement wherein the Investor agrees to fund all or a significant portion of the E&P Company’s required drilling capital for a certain number of wells, often grouped in stages or tranches, in exchange for a working interest in such wells. Interestingly, the use of DrillCo to describe these transactions is a misnomer because the participants do not actually form a new company for the purposes of the drilling joint

venture; rather, the parties enter into an agreement to jointly develop the E&P Company’s oil and gas properties and each party participates as an undivided interest holder of such properties.

In 2017 alone, numerous DrillCos have been publicly announced targeting a variety of oil and gas basins, including several in the Permian Basin, the Anadarko Basin, and the Appalachian Basin.<sup>3</sup> In the past two years, at least two billion dollars have been committed to E&P Companies by Investors in DrillCo Transactions.<sup>4</sup>

While the term DrillCo may be relatively new, most oil and gas industry participants and the lawyers who regularly counsel them

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<sup>3</sup> See *EP Energy, Wolfcamp Drillco enter Permian drilling JV*, OIL & GAS J. (Jan. 30, 2017), <http://www.ogj.com/articles/2017/01/ep-energy-wolfcamp-drillco-enter-permian-drilling-jv.html> (Subsidiaries of EP Energy Corporation and Apollo Global Management LLC enter into DrillCo Transaction in Permian Basin); *Chaparral, Bayou City Energy launch STACK drilling venture*, OIL & GAS J. (Sept. 27, 2017), <http://www.ogj.com/articles/2017/09/chaparral-bayou-city-energy-launch-stack-drilling-venture.html> (Chaparral Energy Inc. and private equity firm Bayou City Energy enter into DrillCo Transaction in the STACK play of the Anadarko Basin); *Eclipse Resources Corporation Announces Second Quarter 2017 Results, a \$325 Million Utica Shale Drilling Joint Venture Commitment Agreement and an Increase in the Company’s Borrowing Base*, ECLIPSE RES. (Aug. 2, 2017, 5:07 PM), <http://ir.eclipseresources.com/press-release/eclipse-resources-corporation-announces-second-quarter-2017-results-325-million-utica-> (Eclipse Resources Corporation and an affiliate of GSO Capital Partners enter into DrillCo Transaction in the Appalachian Basin.)

<sup>4</sup> Ernest Scheyder, *First tech, now financing: U.S. shale firms get creative to pump more oil*, REUTERS.COM (July 13, 2017, 6:14 AM), <https://www.reuters.com/article/us-usa-shale-drillco-analysis/first-tech-now-financing-u-s-shale-firms-get-creative-to-pump-more-oil-idUSKBN19Y17R>.

will recognize that DrillCos share many characteristics with traditional industry joint ventures and multi-well drill-to-earn farm-outs that have been utilized in the oil and gas industry for years, with a few important differences.<sup>5</sup>

The main differences between DrillCo Transactions and the traditional drilling joint ventures they so closely resemble are that the E&P Company remains the operator and the undivided working interest earned by the Investor in the E&P Company's wells is subject to reversion to the E&P Company, in whole or in part, once and if certain specified internal rates of return (each, an "IRR Hurdle") are achieved on the Investor's capital investment in such wells.

Additionally, while drilling joint ventures historically have been between two E&P Companies, today's DrillCo Transactions are most often entered into by an E&P Company and an Investor that is either a private equity firm or a company funded by private equity or other institutional investors, and whose primary purpose is investing in DrillCo Transactions.

While the structure of a DrillCo Transaction is limited only by the creativity of the parties entering into them, there are fundamental structural elements that appear in many recently announced DrillCo Transactions. Additionally, the parties to DrillCo Transactions will likely need to address certain issues that tend to arise in most joint development arrangements. This

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<sup>5</sup> While the term DrillCo may be new to many, the general transaction structure is not and issues related to joint development of oil and gas properties have been previously the subject of various publications, including the following: Michael J. Byrd, Cody R. Carper, Rahul D. Vashi, and Gonzalo D. Castro, *Acquiring Upstream Assets via Joint Ventures: An In-Depth Study of Deal Structures, Key Negotiating Points, Drafting Tips, and Relevant Law*, 9 ENERGY L. ADVISOR, no. 3 (Aug. 2015); John V. Connally IV and Patrick T. Maguire, *Recent Trends in Joint Ventures for Shale Oil and Gas and Other Capital-Intensive Oil and Gas Projects*, 57 ROCKY MTN. MIN. L. INST. (2011); Debra J. Villarreal and Lucas LaVoy, *Oil and Gas Exploration and Development Agreements*, 31 ENERGY & MIN. L. INST. 10 (2010).

paper attempts to identify some of those common structural elements and highlight certain issues that we think should be considered by the parties to DrillCo Transactions and possibly addressed in the definitive agreements.

## II. TRANSACTION DRIVERS

DrillCos have become popular in recent years with E&P Companies and Investors for various reasons. Generally, raising drilling capital has become increasingly difficult for E&P Companies due to headwinds affecting the upstream sector. These headwinds include tighter capital markets, more stringent lending standards in response to legislation passed following the financial crisis in 2008, and increased insolvency risk of E&P Companies.

In addition to these headwinds and market dynamics, E&P Companies and Investors alike may be motivated to enter into DrillCo Transactions for other reasons depending on the particular needs of the E&P Company and Investor.

### A. E&P Company Motivations

One of the main reasons that E&P Companies enter into DrillCos is that they provide an alternative to traditional financing sources such as conventional bank loans or the issuance of securities in the public equity and debt markets. An alternative to these traditional financing sources may be necessary for highly leveraged E&P Companies that are unable to obtain conventional bank financing and that do not want to (or are unable to) issue debt or equity securities, but that own quality oil and gas properties suitable for drilling.

DrillCo Transactions can also provide capital necessary for an E&P Company to continue its planned drilling program and ensure that its leases are maintained by either commencing drilling activities prior to the expiration of the primary term of its oil and gas leases or, following the primary term, by the continuous drilling obligations that may be present in its leases.

Occasionally, E&P Companies may enter into DrillCo Transactions in order to drill enough wells necessary to satisfy minimum volume or delivery commitments that the E&P Company agreed to with midstream service providers when commodity prices were higher. By doing so, the E&P Company can avoid making shortfall or deficiency payments associated with such minimum volume or delivery commitments.<sup>6</sup>

DrillCo Transactions may also be attractive to well-capitalized E&P Companies. For example, an E&P Company may have quality assets that are not competitive for an E&P Company's capital within its portfolio of drilling inventory. The E&P Company may enter into a DrillCo Transaction to develop such drilling inventory without having to take on additional debt or issue equity.

## B. Investor Motivations

For Investors, DrillCos may offer a risk-return profile that is a more attractive investment than other opportunities in the upstream oil and gas sector. DrillCos are often entered into with respect to an E&P Company's oil and gas properties after a particular drilling prospect has been identified, tested, and the risks somewhat reduced from an operational and geological perspective.<sup>7</sup>

Also, some Investors may prefer DrillCos over funding upstream exploration and production management teams because DrillCos allow an Investor to invest directly in the existing reserves of an E&P Company and avoid funding the general and administrative expenses of that start-up

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<sup>6</sup> Nissa Darbonne, *The DrillCo*, OIL & GAS INVESTOR (June 2016).

<sup>7</sup> For an in-depth discussion of risk in unconventional resource plays, see David H. Sweeney, Preston Cody, Susan Lindberg, and Michael P. Darden, *Fracturing Relationships: The Impact of Risk and Risk Allocation on Unconventional Oil and Gas Projects*, 9 TEX. J. OIL, GAS & ENERGY L. 289 (2014).

E&P Company while it searches for acquisition opportunities.<sup>8</sup>

Importantly, DrillCos provide Investors with the opportunity to deploy large amounts of capital with experienced and technologically advanced management teams and quality oil and gas assets. This is an opportunity that may not be otherwise available to the Investor.<sup>9</sup>

Lastly, Investors may also prefer DrillCos over other investments in the upstream oil and gas sector because they may offer better protection of the Investor's investment in the event of an E&P Company bankruptcy. The Investor may be better protected because the Investor, after assignment, owns a real property interest in the assets.

## C. Future Trends

DrillCo Transactions are likely here to stay. Notwithstanding the apparent resilience of current industry headwinds and the likelihood of a lower-for-longer commodity environment, E&P Companies continue to drill longer and longer extended-reach lateral (many of which now regularly exceed two miles in length) with increased proppant loading and tighter fracture stages.<sup>10</sup>

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<sup>8</sup> Darbonne *supra* Note 6 (As the managing partner of an Investor recently said: "We're not giving teams hunting licenses.... We want to go into geologically de-risked situations with drilling inventory and cash-flowing reserves already in place.")

<sup>9</sup> *Id.*

<sup>10</sup> Eclipse Resources, which entered into a DrillCo Transaction with an affiliate of GSO Capital Partners in the Appalachian Basin, has drilled multiple wells over 19,000 feet. Paul J. Gough, *Eclipse Resources drills well with a record 19K-foot lateral*, PITTSBURGH BUS. TIMES (June 16, 2017, 7:20 AM), <https://www.bizjournals.com/pittsburgh/news/2017/06/16/eclipse-resources-drills-well-with-a-record-19k.html>; see also Carolyn Davis, *Laterals 20,000 Feet-Plus A Dream No Longer as Proppant Intensity, Digitization Unleash Waives of Innovation*, NGI'S SHALE DAILY (Nov. 10, 2016), <http://www.naturalgasintel.com/articles/108401->

When these advances and improvements in well design and completion techniques are combined with the increased well densities many E&P Companies now pursue (often utilizing a “wine rack” well spacing pattern or configuration<sup>11</sup>), the need for capital to fund drilling in unconventional resource plays is likely to remain strong. DrillCo Transactions will remain an important method for obtaining that needed capital.<sup>12</sup>

### III. DRILLCO TRANSACTION STRUCTURE

DrillCo Transactions generally provide that the E&P Company will contribute certain of its oil and gas interests (e.g., leasehold interest, overriding interests, farm-in interests, etc.) located in a designated geographic area (“Contract

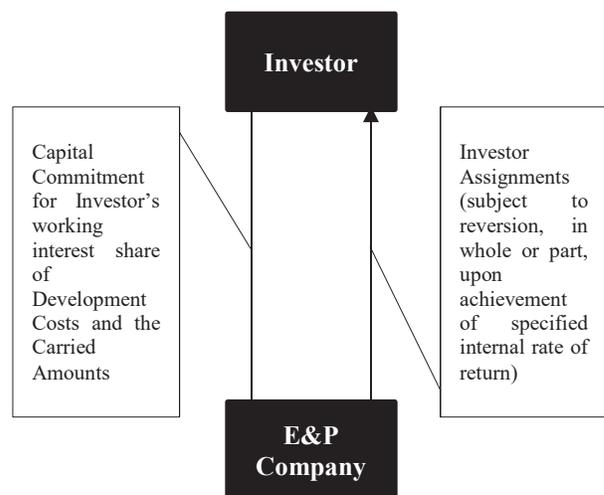
[laterals-20000-feet-plus-a-dream-no-longer-as-proppant-intensity-digitization-unleash-waves-of-innovation.](#)

<sup>11</sup> A “wine rack” well spacing pattern or configuration refers to drilling multiple wells in multiple productive intervals or “benches” that are stacked on top of each other. Typically the group of wells in a productive interval or “bench” will be offset from the wells in the productive interval or “bench” above and/or below. For example, a South Texas E&P Company has utilized a “wine rack” configuration by placing “two wells in the Eagle Ford at 300-foot spacing, and another two wells staggered in the Austin Chalk zone above at 300 feet, each effectively separated by 150 feet in a ‘wine rack’ pattern.” See Steven Toon, *Blackbrush Co-Develops ‘New’ Austin Chalk with Eagle Ford*, Oil and Gas Investor (Monday 2, 2015) <https://www.epmag.com/blackbrush-co-develops-new-austin-chalk-eagle-ford-825726#p=full>.

<sup>12</sup> Leslie Haines, *At Closing: Notes from Near and Far*, OIL & GAS INVESTOR (June 1, 2017, 6:20 AM), <https://www.oilandgasinvestor.com/closing-notes-near-and-far-1595431> (“Finally, if we are taking the long-term view, we are approaching the day when a Permian section can boast up to 50 wells . . . . The call on capital will be enormous. Only two things will suffice: majors and international oil and gas companies with hefty balance sheets will have to take over these resources plays, and every other E&P will compete to secure capital through Drill-Cos and joint ventures with private equity players.”).

Area”) to the drilling venture. In exchange for this acreage contribution in the Contract Area, the Investor agrees to participate in the development of such oil and gas interests in the Contract Area by committing to pay up to a certain dollar amount (“Capital Commitment”) towards the drilling of a certain number of wells in the Contract Area (each, a “DrillCo Well”). Figure 1 below illustrates the exchange that occurs in a DrillCo Transaction.

Figure 1:



The Investor’s Capital Commitment is often allocated to separate stages or tranches of DrillCo Wells (each, a “Tranche”). Participation in Tranches subsequent to the initial Tranche may or may not be mandatory for the Investor, E&P Company, or both.<sup>13</sup> Once the parties agree to a Tranche, however, the parties’ participation

<sup>13</sup> For example, SandRidge Energy, Inc. recently announced a DrillCo Transaction with a private investment fund pursuant to which the private investment fund is required to fund an initial \$100 million in an initial Tranche of wells and, upon mutual agreement a subsequent \$100 million in a second Tranche of wells. Press Release, SandRidge Energy, SandRidge Energy, Inc. Reports Financial and Operational Results for Second Quarter of 2017 (Aug. 2, 2017), <http://investors.sandridgeenergy.com/Investor-Relations/press-releases/press-release-details/2017/SandRidge-Energy-Inc-Reports-Financial-and-Operational-Results-for-Second-Quarter-of-2017/default.aspx>.

is mandatory, and the E&P Company is usually subject to a continuous drilling obligation until all of the DrillCo Wells in a Tranche have been drilled (subject to customary provisions addressing permitted interruptions, such as force majeure).

The Investor's Capital Commitment is used not only to pay its working interest share of certain costs and expenses incurred to drill and complete the DrillCo Wells ("Development Costs") but also to pay all or part of the E&P Company's working interest share of Development Costs in the DrillCo Wells as a carry ("Carried Amounts"). In exchange for Investor's Capital Commitment and payment of the Carried Amounts, the E&P Company will agree to deliver to the Investor an assignment of a specified undivided interest in and to each DrillCo Well wellbore and certain associated oil and gas leasehold interests (each, an "Investor Assignment").

Importantly, the working interest conveyed to the Investor in the Investor Assignment is subject to reversion to the E&P Company, in whole or part, once certain specified IRR Hurdles have been achieved on the Investor's Capital Commitment with respect to such DrillCo Wells. Usually, the IRR Hurdle is calculated on a Tranche-by-Tranche basis, rather than with respect to individual DrillCo Wells.

#### **A. Investor's Capital Commitment**

The Investor's Capital Commitment is generally made on a Tranche-by-Tranche basis. For example, the Investor may commit \$100 million to the drilling of 20 DrillCo Wells in the Contract Area in an initial Tranche and another \$100 million in a subsequent Tranche that follows the completion of the initial Tranche. After each Tranche is completed, the Investor and/or the E&P Company generally have the right to decide whether to proceed with subsequent Tranches. Sometimes the E&P Company is required to propose one or more subsequent Tranches in which the Investor may elect to participate in or at its discretion. Other times, subsequent Tranches are subject to mutual agreement by both the E&P Company and the Investor.

Because the Capital Commitment may be divided among multiple Tranches, each Tranche will be subject to a separate work program and budget agreed to by the parties that sets forth all or a combination of the following:

- the estimated Development Costs for each DrillCo Well to be drilled in such Tranche;
- the expected surface location, bottom hole location, total vertical depth, and total measured depth for each DrillCo Well;
- the total horizontal displacement of each DrillCo Well;
- the proposed drilling unit and/or plats showing the anticipated productive drainhole of such DrillCo Wells;
- the projected spud, completion, and first production dates for each DrillCo Well; and
- the working interest and net revenue interest of the E&P Company in each DrillCo Well.

The work plan and budget for a particular Tranche may also set forth descriptions of alternate wells that can be drilled in lieu of a DrillCo Well in a Tranche in the event the drilling of a particular DrillCo Well is discontinued due to a variety of reasons, including mechanical issues that arise during drilling or geologic issues that make drilling impossible or impracticable (for example, encountering heaving shale during drilling). The work plan and budget for the initial Tranche is typically agreed to by the E&P Company and Investor at the outset of the DrillCo Transaction and attached to the definitive agreement. Following completion of the initial Tranche, the E&P Company will provide a proposed work plan and budget for each subsequent Tranche of DrillCo Wells to the Investor.

The Capital Commitment for a Tranche often contains limits on the Investor's expenditure obligations for each DrillCo Well and for the Tranche in the aggregate. With respect to individual DrillCo Wells in a Tranche, the parties will often negotiate provisions that address overages, such as including deemed approval of overages

within specified tolerances. Outside of such specified tolerances, the definitive agreement will provide for allocation of the excess amount between the Parties, in some cases to be borne solely by the E&P Company. Often, however, overages attributable to emergency situations will be deemed approved by the Investor.

## B. The Carry

Most DrillCo Transactions require the Investor to carry a certain percentage of the E&P Company's share of the Development Costs for each DrillCo Well in a Tranche. While the definition of Development Costs is a point of negotiation, Development Costs are generally defined as those costs and expenses to drill, complete, and equip each DrillCo Well in a Tranche, and will include costs related to permitting, well site construction, drilling, testing, fracturing, and stimulating each DrillCo Well and the installation of flow lines to tanks or sales lines.

## C. Investor Assignments

Of prime importance to the Investor is receipt of the Investor Assignments of the E&P Company's working interest (and potentially other rights) earned by the Investor's participation pursuant to the definitive agreements of the DrillCo Transaction (each, an "Investor Assignment").

The working interest earned by the Investor is typically limited to a wellbore assignment, and may also be depth limited. If the E&P Company and Investor want to limit Investor Assignments to only certain depths, they should sufficiently identify the depths or stratigraphic equivalent of the applicable formation. The most common and perhaps best practice is to refer to a formation by stratigraphic equivalent in a well log.<sup>14</sup> For example, the parties may use

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<sup>14</sup> For a comprehensive discussion on depth limitations, see Tim George, *Depth Limitations: Saying What You Mean* (Mar. 21, 2003), [http://www.mcginnislaw.com/images/uploads/news/03-03-01\\_George\\_depth\\_limitations-saying\\_what\\_you\\_mean.pdf](http://www.mcginnislaw.com/images/uploads/news/03-03-01_George_depth_limitations-saying_what_you_mean.pdf).

the following formulation to define the applicable formation:

**"[ ] Formation"** means the geologic formation generally known as the [ ] formation, being the correlative stratigraphic equivalent of the geologic interval seen between the measured depths of [ ] feet (base) and [ ] (top) on the [ ] log of the [ ] well (API # [ ]) in [ ] County, Texas.

Further, consideration should also be given to providing the Investor with rights to the remainder of the wellbore as may be necessary for conducting operations within the assigned portion of the wellbore, including those operations related to production and the movement of hydrocarbons within the entire wellbore. The same is true of surface facilities, surface rights, contracts, and any other items that might typically be conveyed in conjunction with a transfer of working interests in oil and gas properties.

The timing of the Investor Assignment is an area that typically involves a good deal of negotiation. Investor Assignments can be made on a well-by-well basis, on a Tranche basis or simply on a periodic basis, as negotiated by the parties. Regardless, the timing of such assignments will generally be tied to payment of Development Costs by Investor, the commencement of drilling operations, the completion of DrillCo Wells, or some combination of the foregoing. There may also be situations (related to insolvency or bankruptcy concerns of Investor regarding the E&P Company) in which the Investor would be reasonable in requesting an up-front Investor Assignment, which may cover a greater area than just the wellbore of each DrillCo Well.

The Investor will also likely require that all Investor Assignments be made free and clear of any encumbrances burdening the oil and gas assets to be assigned (except for certain permitted encumbrances, the

definition of which will be negotiated by the parties). In light of such requirement, the E&P Company will need to take actions to ensure that its interests conveyed by way of the Investor Assignments are free and clear of such encumbrances. This will require that the E&P Company work with its existing secured creditors so that any mortgages or security interests (or other liens) burdening its interests to be assigned are released prior to, or contemporaneously with, the delivery of the Investor Assignment to Investor.

#### **D. Reversion of Working Interest**

The commercial terms of a DrillCo Transaction typically require reversion of some percentage of working interest to the E&P Company at such time as the Investor has achieved the IRR Hurdle(s) on its Capital Commitment with respect to such DrillCo Wells or Tranches. In some cases, this may actually be a conversion of all the Investor's working interest to an overriding royalty interest; although, the majority of recent DrillCo Transactions contemplate the Investor retaining a residual working interest in the DrillCo Wells following reversion instead of an overriding royalty interest.

Typically, the IRR Hurdle is either an internal rate of return or a return on investment and is calculated on a Tranche basis, rather than a well-by-well basis, based on the revenues the Investor receives and certain costs and expenses that it pays. Achievement of the IRR Hurdles is often determined using the XIRR function in Microsoft Excel software, but can be determined using any methodology agreed to by the E&P Company and Investor.

It is very important that the parties clearly define which costs and expenses paid by the Investor will be taken into account when determining whether the applicable IRR Hurdle has been achieved on a Tranche or DrillCo Well. The costs and expenses included in the IRR Hurdle calculation are usually broader in scope than just the Development Costs paid by the Investor for its own account and on behalf of the E&P Company as Carried Amounts.

For example, the parties may agree to include marketing and post-production costs and expenses, operating costs and expenses, taxes on production, and delay rentals in determining when the IRR Hurdle is achieved.

Whether or not hedging losses and/or gains of the Investor on its share of production from the DrillCo Wells will be taken into account in determining when an IRR Hurdle is achieved is often a point of contention between the E&P Company and the Investor. The Investor typically wants to include any of its hedging losses in the calculation of the IRR hurdle. If such a request is made, at a minimum, the E&P Company will request that the Investor's gains also be accounted for in determining whether an IRR Hurdle has been achieved.

Further, if the parties agree to include hedging losses and/or gains in the IRR Hurdle determination, the E&P Company may request that there be certain restrictions on the scope of the Investor's hedging activities that may be accounted for in determining whether the IRR Hurdles have been achieved. For example, if the E&P Company agrees to allow hedging losses and/or gains in the IRR Hurdle determination, it may only agree to include such losses and/or gains with respect to Investor's hedges that have market-based floors and only with respect to hedges attributable to a certain specified percentage of Investor's share of production. The right of the E&P Company or the Investor to hedge production is also typically limited to the hedging party's share of production.

Although the reversion of the Investor's working interest will be stated in the definitive agreements and the Investor Assignments to occur automatically upon the Investor's achievement of the applicable IRR Hurdle, the Investor will typically provide a re-assignment of its working interest to the E&P Company once the applicable IRR hurdle is met. The E&P Company generally will want to record such re-assignment in the applicable county real property records.

Figure 2 below is a table illustrating how a DrillCo Transaction with a single IRR Hurdle may be structured.

Figure 2:

	<u>E&amp;P Company</u>	<u>Investor</u>
Pre- Reversion Working Interest & Share of Production	10%	90%
Pre-Reversion Share of Development Costs	0%	100%
Post-Reversion Working Interest & Share of Production	90%	10%
Post-Reversion Share of Development Costs	90%	10%
IRR Hurdle	15%	

In this example, the E&P Company retains a 10% working interest in each DrillCo Well and conveys to the Investor a 90% undivided working interest. Investor agrees to pay 100% of the Development Costs attributable to such DrillCo Wells. The E&P Company will receive 10% of the production attributable to such DrillCo Wells and Investor will receive 90% of the production attributable to such DrillCo Wells until the Investor receives a 15% return on its Capital Commitment (and any additional costs that the parties agree to include in the IRR Hurdle calculation) attributable to the Tranche. Once the 15% IRR Hurdle is achieved, the Investor will re-assign the majority of its working interest in the DrillCo Wells in the Tranche, such that the E&P Company will own a 90% working interest

and the Investor will own a 10% working interest. Costs and expenses attributable to each party's working interest following such re-assignment will be borne on a heads-up basis (*i.e.*, the E&P Company bears 90% of the costs and expenses to operate the DrillCo Wells and the Investor bears 10% of the costs and expenses to operate the DrillCo Wells).

While some DrillCo Transaction structures may contemplate a single IRR Hurdle as described above, the parties may agree to multiple IRR Hurdles. In that case, there would be a partial reversion of the working interests conveyed pursuant to the Investor Assignments upon achievement of the initial IRR Hurdle, with subsequent, incremental reversions upon the achievement of any subsequent IRR Hurdle.

Lastly, the E&P Company may request a right to pre-pay the Investor an amount equal to its Capital Commitment funded for a Tranche plus the return contemplated in the IRR Hurdle less the revenues that the Investor has previously received for the DrillCo Wells in a Tranche. If such a pre-payment right is agreed upon, the Investor's working interest in the DrillCo Wells in the applicable Tranche will revert, in whole or in part, to the E&P Company upon such pre-payment.

#### IV. DOCUMENTING THE DRILLCO

Given the unique nature of each DrillCo Transaction, close attention to the preparation of the definitive agreements that will govern the DrillCo Transaction is paramount to the success of the venture for the E&P Company and Investor. While there may be additional agreements that such parties enter into, most DrillCos are documented by the following, or some variation thereof.

##### A. Development Agreement

The Development Agreement ("Development Agreement") is the key deal document and contains, in its body or in ancillary documents attached as exhibits thereto, the comprehensive expression of the rights and obligations of the parties to

the DrillCo Transaction. In the authors' experience, the Development Agreement may sometimes be called a Participation Agreement, Joint Development Agreement or Joint Exploration and Development Agreement.

In addition to addressing the Investor's Capital Commitment, the Investor's carry and the scope of Carried Costs, and the IRR Hurdle, the Development Agreement will contain provisions typically found in agreements pursuant to which a party acquires or sells interests in oil and gas properties. For example, the Development Agreement will likely include representations and warranties made by each of the parties (including representations and warranties by the Seller with respect to the oil and gas interests subject to the DrillCo Transaction) and related indemnity provisions. With respect to DrillCo Transactions that contemplate multiple Tranches, the Investor may request that the E&P Company bring down (*i.e.*, make again at a specified point in time) any asset-related representations and warranties with respect to the oil and gas properties in the Contract Area. If such a request is made, the E&P Company would need the right to update its disclosure schedules, if any.

The parties may also consider including provisions governing information sharing between the parties and confidentiality provisions. Often, the Investor will request informational rights greater than those which a non-operator typically receives pursuant to a joint operating agreement.

#### **i. Contract Area**

The Development Agreement will set forth with specificity the Contract Area subject to the DrillCo Transaction. The Contract Area may be broadly defined (*e.g.*, the entirety of certain counties) or more narrowly defined. For example, a narrowly defined Contract Area may consist only of the drilling or proration units designated to the applicable DrillCo Wells as contemplated in the applicable work plan and budget for a particular Tranche.

If the Contract Area is limited to certain geologic formations, such formations should be identified by reference to a well log as described in Section III(C) of this paper.

The scope of the Contract Area may be particularly important to the Investor if the Investor is concerned with the E&P Company conducting operations for its own account and outside of the DrillCo Transaction in the same area as the applicable DrillCo Wells. If the E&P Company desires to limit the scope of the Contract Area, the Investor may insist on including certain operational restrictions on the E&P Company in the Contract Area or general area where the DrillCo Transaction takes place.

#### **ii. DrillCo Well Specifications**

While the initial Tranche of DrillCo Wells to be drilled by the E&P Company will likely be agreed to prior to execution of the Development Agreement and set forth on the initial work plan and budget, the parties to a DrillCo Transaction often will agree to certain specifications that all future proposed DrillCo Wells must meet in order to qualify as DrillCo Wells. For any well that the E&P Company proposes to include in a subsequent Tranche that does not meet such specified qualifications, Investor will not be obligated to participate and the E&P Company will be prohibited from drilling such wells during the term of the DrillCo Transaction.

Generally, the DrillCo Well specifications that the parties will set forth in the Development Agreement include at a minimum: (1) the required total lateral length of each proposed DrillCo Well (which may be based on the lateral length of each proposed DrillCo Well individually or on the average of all proposed DrillCo Wells in a Tranche); (2) the specific geologic formation that the proposed DrillCo Well must target; and (3) the minimum E&P Company net revenue interest and working interest in each proposed DrillCo Well.

In addition to the foregoing specifications, the E&P Company may be required to provide the Investor with

information related to the proposed DrillCo Wells, which may include:

- an authorization for expenditure (“AFE”) proposal for such well;
- a plat of the proposed drilling unit and well location;
- a copy of the applicable drilling title opinion;
- identification of all leases that the E&P Company has rights to in the proposed drilling unit; and
- any engineering or geological analysis that the E&P Company has with respect to the expected performance of the proposed well.

### **B. Joint Operating Agreement**

A form of joint operating agreement will generally be attached as an exhibit to the Development Agreement and will be executed (or deemed executed) with respect to each DrillCo Well and its drilling unit, each Tranche of DrillCo Wells and their drilling units, or the Contract Area in its entirety.

Because DrillCo Transactions are entered into often with respect to horizontal drilling in mind, the parties will typically agree to use the A.A.P.L. Form 610 – 1989, Model Form Operating Agreement (Horizontal Modifications). The parties may also decide to use the more recently issued A.A.P.L. Form 610 – 2015, Model Form Operating Agreement, which contains provisions related to horizontal development operations.

### **C. Investor Assignment**

A form of Investor Assignment will also be attached as an exhibit to the Development Agreement and will be executed and delivered at such time as each assignment is earned pursuant to the Development Agreement. The Investor Assignment conveys to the Investor the interest earned (subject to reversion) and will include language with respect to the reversion upon the specified IRR Hurdle(s) being achieved. The Investor will often request that the Investor Assignments contain a special warranty of title. The

parties may also attach to the Development Agreement a form of re-assignment for the reversionary interest following achievement of the applicable IRR Hurdle(s).

### **D. Memoranda of Development Agreement and Joint Operating Agreement**

Generally, the parties will execute a memorandum of the Development Agreement when the Development Agreement is signed. The memorandum will be recorded in the real property records where the Contract Area is located.

Thereafter, the parties will also execute and record one or more memorandum of joint operating agreement, the form of which will be attached to the Development Agreement, with respect to each joint operating agreement that the parties enter into in connection with the DrillCo Transaction.

The memorandum of the Development Agreement and of each joint operating agreement serves to put third parties on notice of the DrillCo Transaction and the terms and conditions that may be contained in the Development Agreement and each joint operating agreement.

### **E. Tax Partnership Agreement**

Because most DrillCo Transactions contemplate that the E&P Company and Investor will bear the Development Costs for each DrillCo Well in a manner that is disproportionate to their working interest in such DrillCo Wells, the parties will often treat the DrillCo Transaction as a partnership for tax purposes. The intent of the parties is typically set forth in the definitive agreements by (i) inserting a provision in the Development Agreement stating that the parties intend to treat the DrillCo Transaction as a partnership for tax purposes and (ii) deleting the election in Article IX of the A.A.P.L. joint operating agreement not to be treated as a partnership under subchapter K of the Internal Revenue Code of 1986, as amended (the “Code”). Further, the parties will enter into a tax partnership agreement

that is negotiated and finalized prior to execution of the Development Agreement. The tax partnership agreement will be attached to the Development Agreement as an exhibit and executed the same time as the Development Agreement.

By electing to be treated as a partnership under subchapter K of the Code and entering into a tax partnership agreement, the parties may be able to ensure all tax benefits from the DrillCo Transaction are realized either by the E&P Company or Investor, including the realization of tax benefits attributable to intangible drilling costs incurred by the parties in connection with the DrillCo Transaction.

While the parties will be treated as partners for tax purposes, it should be made clear in the definitive agreements that the parties do not intend to be treated as partners for any other purpose, including under state law. This is typically accomplished by including partnership disclaimer language in the definitive agreements.

#### **F. Management Services Agreement**

In many situations, the Investor may not be in a position to perform certain management, technical, and administrative support functions related to its interests in the Contract Area and DrillCo Wells, at least not at the outset of the DrillCo Transaction. In such cases, the E&P Company may provide services to the Investor with respect to such functions. Often, the services provided by the E&P Company to the Investor will be provided pursuant to the terms of an agreement separate from the Development Agreement, often called a management services agreement ("MSA").

The services provided may include accounting services (including production accounting), AFE and joint interest billing processing and administration, royalty and tax administration, marketing, regulatory, engineering, and land (including land administration) services, but the services provided will vary from deal to deal.

In addition to the foregoing, the E&P Company may be required to provide certain periodic reports, such as monthly lease operating statements and other customary industry reports, and in limited circumstances, the E&P Company may be required to provide assistance in an Investor sale process if the Investor retains a residual working interest in the DrillCo Wells and decides to sell such interest following reversion.

The E&P Company will be compensated for the services that it provides for the Investor. The compensation can take the form of cost reimbursement plus an agreed additional fee or it can take the form of an agreed monthly fee. In either case, it should be made clear whether the compensation is included as a cost in the IRR Hurdle calculation.

### **V. SELECT DRAFTING CONSIDERATIONS**

#### **A. E&P Company's Title**

Prior to the execution of the Development Agreement, the Investor is unlikely to have much time to perform title diligence of the E&P Company's interests in the Contract Area. Therefore, the Investor may have concerns with respect to the E&P Company's title which can be addressed through a variety of mechanisms following execution of the Development Agreement. The first of these mechanisms would be post-execution diligence rights. But, keep in mind that typically the Investor will be required to conduct its title diligence prior to approval of the work program and budget for each Tranche. For the initial Tranche that due diligence work would occur prior to execution of the Development Agreement. As such, the Investor may require additional protection against title issues. Such protection might include a special warranty of title coupled with a supporting indemnity, a requirement that the E&P Company provide a drill site title opinion to the Investor prior to spudding any DrillCo Well, or an Investor title sign-off right prior to drilling. Typically, one would expect to see a combination of some of these mechanisms, but not all of them.

In the Development Agreement, the parties should also address how consents to assign in the E&P Company's leases within the Contract Area and preferential purchase rights that may burden such leases will be handled. For example, the parties may agree that if certain of E&P Company's leases included in a proposed DrillCo Well's drilling unit contain certain types of consent to assign or are burdened by preferential purchase rights, then the Investor may require that the E&P Company propose an alternate DrillCo Well.

Lastly, the parties should also review any existing third party joint operating agreements that burden the E&P Company's properties in the Contract Area to see if they contain maintenance of uniform interest provisions. The existence of a maintenance of uniform interest provision could hinder the ability of the E&P Company to assign divided interests in the contract area of such joint operating agreements, such as wellbore interests in DrillCo Wells and the drilling unit attributable to such well.

## **B. Security for E&P Company and Investor Obligations**

Because DrillCo Transactions involve significant capital commitments by the Investor and the actual transfer of undivided interest of the E&P Company's oil and gas properties subject to the Development Agreement, the Investor and the E&P Company may have legitimate concerns regarding the ability of the other party to perform its obligations under the Development Agreement.

### **i. Investor Concerns**

The Investor's concerns may relate to the financial viability of the E&P Company and insolvency risk or the E&P Company's ability to make the Investor Assignments of the applicable oil and gas properties free and clear of existing encumbrances (except for certain permitted encumbrances, including those that ordinarily arise in the course of oil and gas operations such as liens arising under joint operating agreements with third parties, for example) as they become due.

Due to the recent number E&P Company-related bankruptcies, many Investors have become acutely sensitive to the effect that an E&P Company's bankruptcy may have on the transaction. For example, while the Development Agreement will often make expressly clear the parties' intent that the Investor Conveyances are absolute transfers of interest in real property and not merely security for a debt, some Investors may be concerned that a bankruptcy court would characterize the transfer of the E&P Company's interest in its oil and gas properties as something other than a transfer of a real property interest. A discussion of whether the transfer of an undivided interest in leasehold interests that is subject to a later reversion based on the achievement of internal rates of return is an absolute transfer in real property or something else is beyond the scope of this paper, but it is worth briefly discussing.

This concern likely arises out of *NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014), a fairly recent case in the United States Bankruptcy Court for the Southern District of Texas. In this case, the court found that there were material issues of fact with respect to whether certain term overriding royalty interests were properly characterized as conveyances of real property or whether they were in fact debt-financing transactions. To alleviate either real or perceived concerns arising out of *In re ATP Oil & Gas Corp.* that a bankruptcy court might characterize a DrillCo Transaction as a debt financing in an E&P Company's bankruptcy, Investors may request that the E&P Company provide a precautionary mortgage to the Investor covering the interests to be earned or already earned. Investors argue that such a precautionary mortgage would provide necessary protection in the event interests it received under the Investor Assignments were characterized as something other than a real property interest by a bankruptcy court.

Concerns related to the E&P Company's ability to make the Investor Assignments may be addressed in the Development Agreement by requiring that the Investor Assignments be made by the E&P Company either at the outset of the DrillCo Transaction with respect to the entire Contract Area or upon the commencement of operations for each DrillCo Well drilled pursuant to the terms of the Development Agreement. E&P Companies may resist this, however, and insist that Investor Assignments not be made until the Investor has fulfilled its funding obligation with respect to the relevant DrillCo Well.

Lastly, if the Investor is required to advance all or a portion of its Capital Commitment to the E&P Company, the Investor may require that such funds be deposited in a deposit account subject to a deposit account control agreement by and between the Investor, E&P Company, and the bank with which the account is held. While such a mechanism is rarely utilized, it may be advisable depending on the E&P Company's financial condition at the time of the transaction.

## **ii. E&P Company Concerns**

The E&P Company's concerns, if any, will focus on the Investor's ability to fund its Capital Commitment. To alleviate these concerns, the E&P Company may request various forms of security for such funding from Investor, including the ability to cash call the Investor prior to the commencement of any operation, requiring the Investor to provide a parent guaranty of its funding obligations, requiring the Investor to post irrevocable letters of credit, or requiring that all or a portion of the Capital Commitment be deposited into an escrow account.

## **C. Off-Ramps**

In a DrillCo Transaction, the Investor has made its Capital Commitment based on expected production results from an agreed work program and budget for each Tranche of DrillCo Wells that the E&P Company will drill. Typically, the E&P Company has assisted the Investor with deriving those

expected production results, although no representation and warranty would be given in that regard by the E&P Company with respect to production results. Because the production results may not turn out to be what the Investor originally had assumed for a variety of reasons, the Investor may consider including in the Definitive Agreements a right to modify, and perhaps even terminate, its Capital Commitment if the expected production results are not realized from the DrillCo Wells.

Capital Commitments are typically made on a Tranche-by-Tranche basis, with each Tranche having a separate work program and budget. If, for Tranches subsequent to the initial Tranche, the parties are unable to come to agreement on the work program and budget, there is usually no commitment by the parties to proceed into any subsequent Tranche. As such, there may be a de-facto off-ramp at the end of each Tranche in a DrillCo Transaction.

The parties entering into DrillCo Transactions generally recognize that certain minimum commodity prices are necessary to justify drilling out the Contract Area. As such, the terms of a DrillCo Transaction entered into in a relatively high commodity price environment might allow either party to suspend its obligations if a certain floor is breached. The task then is to decide whether, after some period of suspension, the Tranche (and all calculations related to the Tranche) may be truncated to the drilling done and expenditures made as of the date of the truncation.

## **D. Restriction on Transfers**

Keep in mind that, as with most joint developments, each of the Investor and the E&P Company enters into the DrillCo Transaction on an informed basis, knowing the technical, operating, and financial strength or capacity of the other party. Therefore, it is not unusual to see transfer restrictions that prevent either the E&P Company, the Investor, or both, from transferring their interests in the

Development Agreement or the DrillCo Wells.

Transfer restrictions in the Development Agreement may include outright prohibitions, restrictions based on timing the timing of such transfers (such as completion of a Tranche, fulfillment of payment obligations, or achievement of an IRR Hurdle), or pre-emptive rights (such as rights of first refusal or rights of first offer).

Transfer restrictions are a thoroughly negotiated area in DrillCo Transactions and can often leave the parties negotiating the DrillCo Transaction at loggerheads.

#### **E. Tag Rights; Drag Rights**

It is not unusual for the Investor to request the ability or right to tag-along in the event of an E&P Company transfer of its interests in the DrillCo Wells or Contract Area, which tends to be a matter of value preservation for the Investor. If a tag-along right is requested by the Investor, the E&P Company may request a corresponding drag-along right.

A related issue that may be raised by the E&P Company is its right to purchase the residual working interest, if any, that the Investor may retain in the DrillCo Wells following achievement of the applicable IRR Hurdle. However, such a right can be difficult to negotiate given the inherent difficulty in determining the value of such interest at the time the Development Agreement is executed. However, in lieu of a call or purchase right on the Investor's residual interest, the E&P Company may reserve a preferential purchase right or right of first offer on Investor's residual interest.

#### **F. Marketing Production**

In DrillCo Transactions, the E&P Company often wants the right to transport and market the Investor's share of production. This is particularly true if a DrillCo Transaction is entered into in order to satisfy midstream minimum volume or delivery commitments or justify midstream buildouts in an undeveloped or recently developed area. Such joint marketing

operations are often addressed in either the Development Agreement or MSA. While Investors often are agreeable to such an arrangement, the Investor may include a right to take its share of production in-kind and market it separately from the E&P Company.

#### **G. Joint Use**

To some, it may seem inappropriate to allow the E&P Company to conduct operations (either horizontal wells or vertical wells) on its retained acreage within the Contract Area that compete with operations conducted, or to be conducted, as part of the DrillCo Transaction.

If the E&P Company is permitted to conduct operations in the Contract Area other than those contemplated by the DrillCo Transaction, the Development Agreement should address, at a minimum, spacing and drainage issues with respect to DrillCo Wells and non-DrillCo Wells. If stronger protection is requested by the Investor, the parties may agree to the use of an area of mutual interest provision which allows the Investor to participate in the AMI acreage on terms similar to those applying to the DrillCo Contract Area, or otherwise provide for express restrictions on the E&P Company's ability to conduct its own operations within certain specified areas.