RUMINATIONS ON CONTRACT DRAFTING: BEST PRACTICES IN DRAFTING FORM AGREEMENTS

MELISSA A. LOVELL
Gordon, Arata, McCollam, Duplantis & Eagan, LLP
One Riverway, Suite 1300
Houston, Texas 77056

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MELISSA A. LOVELL
Gordon, Arata, McCollam, Duplantis & Eagan, LLP
One Riverway, Suite 1300
Houston, Texas 77056
713-333-5500
FAX: 713-333-5501
mlovell@gordonarata.com

BIOGRAPHICAL INFORMATION

EDUCATION

B.S. in Economics and Political Science, *summa cum laude*, The University of Houston
J.D., *cum laude*, The University of Houston Law Center

PROFESSIONAL ACTIVITIES

Associate, Gordon, Arata, McCollam, Duplantis & Eagan, LLP
Member, Business Law Section, State Bar of Texas
Member, Business Law Section, American Bar Association
Graduate, Leadership Pearland 2006-2007

LAW RELATED PUBLICATIONS

Co-Author/Speaker for the 55th Annual Mineral Law Institute 2008

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RUMINATIONS ON CONTRACT DRAFTING: BEST PRACTICES IN DRAFTING FORM AGREEMENTS[1]

I. INTRODUCTION

A. Purpose

The purpose of this paper is to address a number of recommended practices for preparation of agreements typically utilized in the energy industry. General contracting principles that should be considered when drafting any type of agreement will be discussed and then certain agreements used within the oil and gas business will be analyzed. Finally, special considerations that the drafting attorney may need to examine will be addressed. Specifically, this paper is meant to assist attorneys in preparing and drafting a "forms library" of agreements for a client in the oil and gas business. For example, imagine that a new client seeking to enter into the oil and gas business asks the attorney to prepare all of the "standard" documents that will be necessary in these transactions. How and where does one begin?

B. Where to Begin

Every agreement, regardless of type, has a standard structure that should be utilized. The efficient practitioner should prepare a "bare bones" agreement that has this standard structure. Anytime the attorney must prepare a contract "from scratch," this standard agreement may then be broadened, elaborated upon, and adapted so that it is appropriate for the client's particular needs. Although many model forms exist within the oil and gas industry, the role of the form nevertheless occupies a paramount position in the drafting process. This is especially true when an industry standard model form is not available. After suggesting general principles to use when drafting any type of agreement, this paper will then discuss considerations specific to agreements used in the energy industry.

II. FORMS AND TEMPLATES

A. Electronic Document Aids

One means to improve drafting skills is to create a template from which to work. A template is a means to create a standard document and may either contain complete provisions or be limited to layout and to styles. The latter can include the most basic formatting of your documents as well as the more elaborate headers and footers. Setting choices in one template will allow the legal drafter to be consistent in the style of his or her documents and enable him or her to prepare contracts and agreements more efficiently.

1. Electronic Internal References

Internal references are useful for many reasons. They allow the attorney to easily update internal references each time a draft of an agreement is revised and also enable the reader to go directly to the section or article of the paper referred to in a table of contents or a cross reference**.** Each of the following internal reference methods can be created with word processing programs and are found in the index and tables "insert" selection of Microsoft Word. Other programs will have similar tools. The drafter may use the preexisting formats or customize to suit particular needs. For oil and gas trade documents, the table of contents and cross-references functions will be used more frequently, while for court documents and scholarly papers, the table of authorities and footnotes functions are important tools.

a. Table of Contents

The Table of Contents is created at the time the document is drafted. Each time there is a new article, section or sub-section created in the documents, the words are marked by levels to create the Table of Contents. The convenience of being able to update the table of contents as drafts are revised cannot be overestimated. If you are creating a lengthy purchase and sale agreement, parties reviewing the documents will be able to link to specific articles or sections of the document.

b. Cross References

If creating a document with attachments and exhibits, the cross-reference function allows the drafter to tie together the internal document references with links that allow the reviewer or reader to quickly find the relevant place in the document. One may mark the document by numbered item (i.e. an outline) headings, footnotes, endnotes, etc. and also by page or paragraph number.

c. Table of Authorities

All references to authority in a paper or court filing may be automatically inserted by the use of this tool. It creates the table from data entered and marked electronically.

d. Footnotes

The automatic function allows renumbering when footnotes are added or deleted. Endnotes may be

[1] The author acknowledges, with great appreciation and full attribution, the contribution, scholarship, and assistance of Ms. Kit Reynolds in connection with this paper, a version of which was previously presented at the 55th Mineral Law Institute and was co-authored by this author and Ms. Reynolds.

created using the same function or footnotes and endnotes may be converted from one to the other.

2. Headers and Footers

Preset headers and footers in documents allow the drafter to automatically set page numbers, document name or number, the date and time of the completion of a draft, the author of the document, or any other information desired. Some of the information may be inserted so that it is automatically updated as new drafts are created. This function may be invaluable in keeping straight different versions of a document.

3. Comparing Documents

Many attorneys use a proprietary program to compare different versions of documents. These programs are not always available to clients, but the reviewing function of a word processing program (e.g. the track changes tool in Microsoft Word) can accomplish the same task. It allows both the drafter and the reviewer to quickly find and compare all revisions to a document. The client and other parties to an agreement may easily determine which party made the changes, and it also allows comments to be inserted by the parties reviewing or drafting the document.

4. Execution and Acknowledgment

Although these are not difficult conceptually, signature and acknowledgment blocks require careful drafting to comply with statutory requirements. A document that is going to be recorded must meet the requirements of the jurisdiction in which it will be filed, or the document may be returned by the recorder's office. The drafter can save time by incorporating the form of acknowledgment into the template. Many clients may work with different entities, whether for operating purposes, tax purposes, or other reasons. At each turn the drafter should ensure that the correct entity is actually executing the document. The state of incorporation or registration for each entity on whose behalf the agreement is executed must also be known.

B. Drafting Tips

1. General Principles

In the subsequent sections, emphasis is placed on what is included in an agreement, how the agreement is organized, and the process of creating an agreement that is based upon the terms of the trade or the deal terms.[2] Concurrently with the appropriate emphasis being placed on the substantive terms of an agreement, another important aspect is how the agreement is written. "We lawyers do not write plain English. We use eight words to say what could be said in two. We use arcane phrases to express commonplace ideas. Seeking to be precise, we become redundant. Seeking to be cautious, we become verbose. Our sentences twist on, phrase within clause within clause, glazing the eyes and numbing the minds of our readers."[3] With the goal of clarity and brevity in mind, the following are suggestions to help one draft more clearly.

2. "Shall" and Words of Authority

Legal drafters often misuse the word "shall." Properly used, "shall" creates a duty that attaches to a particular individual. Some commentators advocate eliminating the word altogether because of its prevalent misuse. However, if properly used, "shall" is more concise. For example, "must" does not create a duty; it only asserts that a duty exists. On the other hand, using "shall" in an agreement conveys that a duty arises from that provision. When drafting, if a word of authority is necessary but a duty is not being created, consider using the following in place of "shall": [4]

a. "must" — is required to

b. "must not" — is required not to; is disallowed

c. "may" — has discretion to; is permitted to

d. "may not" — is not permitted to; is disallowed from

e. "is entitled to" — has a right to

f. "should" — ought to

g. "will" — [one of the following]

(1) (to express a future contingency)

(2) (in an adhesion contract, to express the strong party's obligations)

(3) (in a delicate contract between equals, to express both parties' obligations)

The word "shall" is also misused in definitions. Agreements often define terms as follows: For purposes of this Agreement, the term "Buyer" shall mean ABC Corporation. There is no need to use

[2] *See* J. Lanier Yeates, *Best Practice in Contract Drafting*, presentation to the International Quality & Productivity Center: Advanced Contract Risk Management in Upstream Oil and Gas-Americas 2006, June 21, 2006 (on file with author).

[3] RICHARD C. WYDICK, PLAIN ENGLISH FOR LAWYERS 3 (4th ed.1998).

[4] *Id.* at 67.

"shall" to define terms in this manner. It is less wordy and more correct to omit "shall" and simply state: For purposes of this Agreement, the term "Buyer" means ABC Corporation.

3. Consistency

a. In General

It is extremely important to be consistent when drafting agreements. Choose a style and numbering format and use it throughout the agreement. Once a particular phrase or punctuation style is used, strictly apply it throughout the agreement. If an agreement does not utilize a consistent style convention, it suggests that the drafter is either an unsophisticated legal drafter or that he or she is simply sloppy. One of the first things that a transactional attorney who reviews and drafts agreements on a daily basis will notice when reviewing an agreement for the first time is inconsistencies within the style of the agreement. For example, a defined term may be underlined in one part of the agreement, and another defined term found later in the document may be italicized. Either convention is appropriate but pick one and use it consistently throughout.

Additionally, if the agreement is later scrutinized during litigation, a court may determine that the use of different phrases to describe the same thing was done intentionally, which may result in an unintended and negative outcome for the client.

If multiple agreements exist for one transaction, it is also important to remain consistent throughout all of the related agreements. For example, if one has referred to the parties in one agreement as the "Buyer" and the "Seller," then a related agreement should not refer to the parties as "Purchaser" and "Seller." Keep in mind that instruments pertaining to the same transaction may be read together to ascertain the parties' intent, even if the parties executed the instruments at different times.[5]

b. Use of Precedent

Attorneys strive for efficiency, and it often does not make sense to "reinvent the wheel" when drafting a new agreement. Using existing agreements as precedent to prepare a new agreement often makes sense and is a good time saver. However, whether using an existing document as a starting point, or simply cutting and pasting provisions from other forms into an agreement, make sure to conform the styles and defined terms. It is often very apparent when a drafter has cut and paste a particular provision into an agreement because the style or the defined terms or both are not the same as the rest of the agreement.

4. Numbers[6]

It is often necessary to include numbers in an agreement, such as a purchase price or to reflect an interest being conveyed. Although some drafters prefer to both write out the number in words and to state the number itself (they feel it is more clear), this practice presents more opportunities to make a mistake so that the amount intended by the parties is ambiguous. If writing out the words and stating the number in the same clause, ensure that they are consistent. Otherwise, one may end up with the following: The purchase price for the assets is five million dollars ($500000.00).

5. Other Specific Suggestions

Many of the words and expressions drafters utilize may not contribute to the goal of writing with clarity. Several are identified for your consideration: [7]

a. "as such" — A connector that may be useful in persuasive and argumentative writing but, as a connector, should be avoided in drafting agreements.

b. pronouns — Pronouns should not be utilized in an agreement in instances where a proper name, defined term, or other antecedent may be substituted. Although intended antecedents may be clear to the drafter, if disputes over interpretation lead to litigation, others may urge an alternative interpretation. This suggestion is based on avoiding ambiguity, enhancing clarity, and eliminating the pitfalls of a confused antecedent or ambiguous reference.

c. "aforesaid," "hereinafter," "hereby," "hereof," "herein," and "hereinbelow" — Assuming that these words in context have meaning, because of the inherent problem with confusion over the intended reference, these words should be avoided. Utilization of the word "aforesaid" may be intended by the drafter to refer to a prior provision or section in the same document. The better approach is to make specific reference to the provision or section that is the intended reference or antecedent. Utilization of the word "hereinafter" presents the same problems as utilization

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[5] *IP Petroleum Co., Inc. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888, 898 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (citing *Ft. Worth Independent School Dist. v. City of Ft. Worth*, 22 S.W.3d 831, 840 (Tex.2000)).

[6] HOWARD DARMSTADTER, HEREOF, THEREOF, AND EVERYWHEREOF: A CONTRARIAN GUIDE TO LEGAL DRAFTING 11-13 (American Bar Association 2008).

[7] Yeates, *supra* note 2 (citing MARVIN GARFINKEL, AMERICAN LAW INSTITUTE-AMERICAN BAR ASS'N, REAL WORLD DOCUMENT DRAFTING – FORM, STYLE AND SUBSTANCE (American Law Institute - American Bar Association Course Book LZ66, April 27, 2006).

of the word "aforesaid." Utilization of the word "hereby," which may be intended to mean "by means of this agreement" or may signify an immediacy of taking effect as a result of the subject agreement, often is unnecessary and may be confusing. Again, with "hereby," a question of reference is interjected into the document, that is, whether the intended reference is the entire agreement or a particular provision. The meaning of the drafter is more clearly expressed by utilizing "the parties intend" rather than "the parties hereby intend."

d. "forthwith" — Contrary to popular notions of the meaning of "forthwith" as "simultaneously" or "instantaneously," case law suggests that the meaning is "diligently," "without unreasonable delay," "with all reasonable dispatch," or, interestingly, "with all reasonable dispatch consistent with the circumstances." Although there may be times when the drafter would prefer to employ the term and gain flexibility based upon its interpretation by the courts, in other instances, the drafter may desire to be specific and avoid utilizing a term that is indefinite and has been the subject of interpretation by the courts that may not be consistent with the objectives of the drafter.

e. "said" — If for no other reason than for similarity to spoken English, the drafter may desire to substitute the word "such" for the word "said." However, for clarity of reference, utilization of the word "said" should be avoided. Utilization of "said" by the drafter may or may not be intended to limit reference to a specific term, as it was utilized in an agreement, or limit reference to a specific document that was previously described in the document.

f. "any," "all," and "every" — Reported decisions indicate, contrary to what may seem reasonable, that, in a number of contexts, "any" generally means "all" or "every." Authority exists in at least one decision that the word "any" may be utilized to indicate "all" or "every" as well as "some" or even "one." The drafter should carefully consider the context when utilizing the word "any."

g. "and/or" — Judges and legal writing commentators alike are very hostile of the phrase "and/or." Although it means "one or the other or both," to prevent ambiguity, avoid using it. Additionally, one must determine whether the "or" is intended to be inclusive or exclusive. The inclusive use of "A or B" is best expressed as "A and B or either of them." The exclusive use of "or" is best expressed as "either A or B but not both."[8]

h. "in order to" — Generally, the drafter should refrain from utilizing the words "in order to" and, instead, utilize the word "to." Sentence construction utilizing "in order to" or "to" may produce a non sequitur — grammatically, a dangling modifier. Although it may be tempting when describing legal requirements to begin a sentence with the words "in order to" or "to," the drafter should check for continuity and consider alternatives rather than lead to a non sequitur. Sometimes, the drafter can write with clarity and avoid utilizing an "in order to" or "to" in the construction of a sentence. Generally, the drafter can recast a sentence to avoid the pitfall of a dangling modifier.

C. Form of the Agreement[9]

1. Title

The title of the agreement should be centered at the top of the first page and typed in all caps. The title should clearly reflect what type of agreement it is. For example, use "Master Service Agreement" rather than "Agreement."

2. Preamble or Introductory Clause

The preamble or introductory clause follows the title. In general, it states the type of agreement, the date of the agreement, and the parties' names.

a. Type of Agreement

When referencing the type of agreement, use the same wording that is used in the title.

b. Date of Agreement

Use the more modern format *September 26, 2008*, rather than *this 26th day of September, 2008*. Unless stated otherwise in the agreement, the date listed in the preamble is the date the agreement becomes effective. To prevent confusion, do not include a date anywhere else in the agreement, including the signature block. However, if the parties are unlikely to sign the agreement on the same day, one may want to omit the date from the preamble, have the parties date their signatures, and include a provision stating that the agreement only becomes effective once the last party signs. Additionally, if the parties intend for the agreement to become effective after signing, do not

[8] Yeates, *supra* note 2 (citing R. Dickenson, *The Difficult Choice Between "and" and "or,"* 46 A.B.A. Jr. 310 (March, 1960)).

[9] *See generally*, KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING (American Bar Association 2004, 253 pages).

include the effective date in the preamble. Use the date of signing instead and specify in the body of the agreement that it does not become effective until a specified later date.

c. Parties' Names

Identify individuals by their full name and entities by their registered name as stated in the official entity records of the jurisdiction of organization. After the name of the entity, state its jurisdiction of organization and the entity type. For example, *Oil and Gas Exploration, LLC, a Texas limited liability company*.

d. Extraneous Information

The following extraneous information should not be included within the preamble:

(1) Parties' addresses — This should be included within the notice provision.

(2) Statement that a party is represented by a duly authorized representative — This should be addressed in a representation.

(3) Statement that a party is duly organized and validly existing — This should be addressed in a representation.

(4) Statement that the agreement is the binding agreement of the parties — This should be addressed in a representation.

(5) Statement that the parties intend to be legally bound—This may be omitted because it is not a requirement for an enforceable contract.

3. Recitals

Recitals state the relevant background information of the parties and serve as a lead-in to the body of the agreement. Court use recitals to help determine the parties' intent but regard them as subordinate to the body of the agreement, so do not address the parties' rights, obligations, and representations in the recitals. Some courts have held that recitals are conclusive evidence of the facts they state. Do not include any facts in the recitals that the client is not sure are correct.[10] Also, do not state anywhere in the agreement that the recitals are "incorporated by reference." Finally, there is no need to use a heading such as "RECITALS" or "BACKGROUND."

a. Types of Recitals

There are four kinds of recitals:

(1) Context Recitals. These describe the conditions leading up to the transaction. The parties' business operations may be included.

(2) Purpose Recitals. This is a brief description of the purpose of the intended transaction.

(3) Simultaneous-Transaction Recitals. If applicable, the agreement may also include recitals addressing agreements being entered into simultaneously with the current agreement.

(4) The Lead-In. The "lead-in" is the last recital in the agreement. It does not contain any background information and simply states that the parties agree to what follows.

b. Use of "Legalese"

Advocates of the "plain English" movement argue that drafters should not use legalese such as "WITNESSETH," "WHEREAS," and "NOW, THEREFORE" because each of these is archaic and unnecessary. The drafting attorney should determine whether to use these terms based on personal preference. One may also want to consider using complete sentences in the recitals rather than clauses ending in semicolons.

4. The "Lead-In" or Consideration Clause

Again, advocates of "plain English" contend that the last recital should simply state: "The parties therefore agree as follows:" rather than using "NOW, THEREFORE, in consideration of the premises and mutual covenants set forth herein and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto covenant and agree as follows." Regardless of the drafting attorney's personal preference, an expression of consideration should not be omitted entirely. Since courts give some weight to recitals when determining whether a promise is supported by consideration, draft recitals in a way that contains information showing the parties' promises are supported by consideration.

5. Definitions

Many attorneys include a definitions section at the beginning of the agreement directly following the Recitals. If one incorporates a definitions section, the definitions should be in alphabetical order for easy reference and should include either the definition itself or a reference to the section of the agreement where that particular term is defined.

Another convention is to define terms as they are used within the Agreement. For example: This Agreement is effective as of September 1, 2008 (the "Effective Date"). In some cases, one may need to use a defined term before it has been defined. If this

[10] THOMAS R. HAGGARD, LEGAL DRAFTING IN A NUTSHELL 44 (2d ed., West 2002).

occurs, capitalize the defined term the first time it is used in the agreement and use a parenthetical to explain that the term is later defined. For example: Each Party agrees that it will not disclose the other Party's Confidential Information (as hereinafter defined). Some drafters do not like using "hereinafter" (in fact, in this instance, the author may seem hypocritical- see Section II.B.5.c. above). If one does not want to use "hereinafter," then the parenthetical may cross-reference the section where the term is defined (this may also make an agreement more reader-friendly). For example: Each Party agrees that it will not disclose the other Party's Confidential Information (as defined in Section 8(a)). The downside to this method is that subsequent revisions may make the reference incorrect, so a drafter that utilizes this method should diligently check cross-references each time a new draft is prepared. Another choice is to simply state "(as defined below)." Finally, if using this method where the terms are defined as they are used in the agreement, there is no need to continue to use a parenthetical once the term is defined. If a term is defined earlier in the agreement, do not continue to use a parenthetical such as "(as defined above)" every time that term is used following the definition.

6. Body

The main body of the agreement contains the main terms or substantive provisions of the parties' transaction. This part of the agreement should be well organized and contain headings, sections, and subsections. Provisions typically included within the body of the agreement are the business terms, representations and warranties, rights and obligations, insurance requirements, indemnities, actions constituting default, and remedies. These terms are very much transaction specific and highly negotiated between the parties.

7. Miscellaneous

In general, these provisions address administration of the agreement and some of them may be known as "boilerplate."[11] Given that many of these miscellaneous and boilerplate provisions are included within most agreements, it is suggested that the drafter compile a database that includes numerous examples for each provision. When drafting an agreement, the attorney may then look to the database to locate the appropriate miscellaneous provisions that may easily be inserted into the agreement. However, before automatically inserting a particular provision, always consider whether the provision needs to be revised to better reflect the particular transaction. Do not include any boilerplate provision unless it is appropriate and worded properly for the transaction. The following is a list of common miscellaneous and boilerplate provisions (in no particular order). Please note that these are very brief summaries of common boilerplate provisions – entire books and papers have been dedicated to the subject of miscellaneous provisions alone.

a. Notice

This provision describes who the notice must be sent to, where, and by what means. Be sure to indicate when a party is deemed to receive notice. To modernize a notice provision to reflect that much of today's communication is done by email, the drafting attorney may want to update his or her standard notice provision to include email as an acceptable method to send written notice.

A sample provision is:

> Any notice provided or permitted to be given under this Agreement must be in writing, and must either be by: (i) email; (ii) facsimile; (iii) personal delivery; or (iv) registered or certified mail (with a return receipt requested and postage prepaid). Notice deposited with the U.S. Postal Service in the manner described above is deemed given and received on the date of the delivery as shown on the return receipt. Notice served in any other manner is deemed given and received only if and when actually received by the addressee (except that notice given by facsimile is deemed given and received upon receipt only if received during normal business hours and if received other than during normal business hours is deemed received as of the opening of business on the next business day, and notice by email is effective immediately upon transmittal to the other Party, provided that a printed copy of the email sent is preserved showing the date and time of transmission). For purposes of notice, the email addresses, facsimile numbers, and municipal street addresses of the Parties are as follows:
>
> Notices to Seller: _____
> _____
> Houston, Texas _____
> Attn: _____
> Email: _____
> Facsimile No.: _____
>
> Notices to Buyer: _____

[11] *See generally, Id.* at 45-50 (discussing the development of the term "boilerplate" and various boilerplate provisions).

Houston, Texas _____
Attn: _____
Email: _____
Facsimile No.: _____

Each Party has the right to change its address for notice to any other location by the giving of written notice to the other Parties in the manner set forth in this Section.

b. Arbitration

If the client desires an arbitration clause, state information such as where the arbitration will take place, how many arbitrators there will be, and how the arbitrators will be selected.

A sample provision is:

All disputes arising out of or in connection with this Agreement, or any determination the Parties are required to make and to which the Parties are unable to agree, will be settled by arbitration in Houston, Texas. Either Party may submit a matter to arbitration, and unless otherwise agreed by the Parties, a panel of three arbitrators will determine any matter submitted to arbitration. Each arbitrator must be a person experienced in the oil and gas industry. Arbitration will be chosen: (i) by mutual agreement of the Parties; or (ii) failing such agreement within 60 days of the request for arbitration, each Party shall appoint 1 arbitrator and the third arbitrator shall be chosen by the two arbitrators selected by the Parties. If the Parties or the selected arbitrators fail to appoint the arbitrator(s) within 120 days of the request for arbitration, the arbitrator(s) will be selected in accordance with the rules of the American Arbitration Association (the "AAA"). The arbitration will be conducted in accordance with the rules of the AAA. Any award by the arbitrators will be final, binding, and not appealable, and judgment may be entered in any court of competent jurisdiction.

c. Entire Agreement/Merger Clause

This provision makes clear that the agreement is the final and complete agreement of the parties.

A sample provision is:

This Agreement, including the attached Exhibits and Schedules (which are incorporated by reference), constitutes the entire agreement between the Parties and supersedes all previous letters of intent, agreements, understandings, negotiations, and discussions, whether oral or written, between the Parties. No supplement, amendment, alteration, modification or waiver of this Agreement is binding unless executed in writing by the Parties.

d. Execution/Counterpart

If all parties are not signing the agreement at the same time, this provision makes clear that all counterparts taken together have the same effect as if all of the parties had signed the same document. A statement that facsimile signatures are equivalent to original signatures may also be included.

A sample provision is:

This Agreement may be executed in any number of counterparts which taken together constitutes one and the same instrument and each of which is considered an original for all purposes.

e. Further Cooperation/Further Assurances

This provision may be included to require the parties to take certain actions necessary to carry out the intent of the agreement after the agreement is signed.

A sample provision is:

After the Closing the Parties shall, at the sole cost and expense of the requesting Party if more than an immaterial expense is involved: (i) furnish such additional information; (ii) execute and deliver such additional documents; and (iii) perform such additional acts, as may be necessary and reasonably requested by the other Party or Parties to effect the transaction contemplated by this Agreement.

f. Governing Law

This provision identifies which state or national law the parties want the court to use in construing and enforcing the agreement. The law chosen to govern interpretation of the contract is usually the law of the state in which the parties are located, although the parties may wish disputes over the terms of a contract to be governed by the law of the state in which the property is located. Absent this provision, conflicts law determines the governing law.

Note that there may be circumstances under which Texas law requires a governing law provision to be conspicuous. If: (i) the contract relates to the sale, lease, exchange, or other disposition of goods for the

price, rental, or other consideration of $50,000 or less; (ii) any element of the execution of the contract occurs in Texas and a party to the contract is either a Texas resident or a Texas entity (or an entity that has its principal place of business in Texas); and (iii) Section 1.301 of the Uniform Commercial Code does not apply, then an agreement that contains a governing law provision stipulating that the law of another jurisdiction will apply must be set out conspicuously in writing that is bold-faced, capitalized, underlined, or otherwise set out in such a manner that a reasonable person against whom the provision may operate would notice. If the provision is not conspicuous, it is voidable by the party against whom it is sought to be enforced.[12]

A sample provision is:

THE LAWS OF THE STATE OF LOUISIANA (WITHOUT REGARD TO CHOICE OF LAW PRINCIPLES) GOVERN ALL MATTERS ARISING OUT OF OR RELATED TO THIS AGREEMENT.

g. Choice of Venue

This provision states the jurisdiction in which the parties must bring a claim. Sometimes venue is mandated. For instance, in Texas, a case involving a title dispute must be tried in the county or parish where the property involved in the dispute is located. However, most clients will prefer that contract disputes be tried in the county where their corporate offices are located. Note that it is a good idea to make this provision conspicuous, as well.

A sample provision is:

ALL ACTIONS OR PROCEEDINGS WITH RESPECT TO, ARISING DIRECTLY OR INDIRECTLY IN CONNECTION WITH, OUT OF, RELATED TO, OR FROM THIS AGREEMENT OR ANY OTHER DOCUMENT REFERRED TO IN THIS AGREEMENT MAY BE LITIGATED, AT THE SOLE DISCRETION AND ELECTION OF ANY OF THE PARTIES, IN COURTS HAVING SITUS IN HOUSTON, HARRIS COUNTY, TEXAS. EACH PARTY HEREBY SUBMITS TO THE JURISDICTION OF ANY LOCAL, STATE, OR FEDERAL COURT LOCATED IN HOUSTON, HARRIS COUNTY, TEXAS, AND HEREBY WAIVES ANY RIGHTS IT MAY HAVE TO TRANSFER OR CHANGE THE JURISDICTION OR VENUE OF ANY LITIGATION BROUGHT AGAINST IT BY ANY PARTY IN ACCORDANCE WITH THIS SECTION.

h. Limitation of Damages

This provision makes clear that if a party defaults, the party's damages are limited to actual damages and incidental, consequential, special, indirect, multiple, statutory, exemplary or punitive damages are not recoverable.

A sample provision is:

Notwithstanding any other provision of this Agreement (or any other related agreement) to the contrary, in no event will either Party be liable to the other or entitled to recover incidental, consequential, special, indirect, multiple, statutory, exemplary or punitive damages. This limitation of damages provision survives the termination of this Agreement without limit.

Note that if an agreement includes an arbitration clause, then this provision should be drafted to expressly preclude the awarding of consequential and punitive damages. Unless expressly and unambiguously precluded, an arbitration tribunal may award these types of damages, and a court may subsequently uphold such an award.[13]

i. Severability

This provision states that if a court declares any part of the agreement void or unenforceable, the remainder of the agreement is unaffected.

A sample provision is:

Every provision of this Agreement or incorporated into this Agreement from other documents is intended to be severable. If any term or provision is illegal or invalid for any reason whatsoever, such illegality or invalidity will not affect the validity of this Agreement.

[12] TEX. BUS. & COMMERCE CODE ANN. § 35.53 (Vernon 2007).

[13] *See generally*, Michael D. Nolan, *The Punitive Damages Remedy: Lessons for Drafters of Arbitration Agreements*, Dispute Resolution Journal (November 1, 2005), *at* http://www.allbusiness.com/legal/litigation/1051154-1.html, last visited on August 10, 2008.

j. Modification

This provision requires the parties' written consent to modify or amend the agreement.

A sample provision is:

> This Agreement may not be modified or amended without the mutual written consent of the Parties.

k. Publicity

Although this is not a "standard" miscellaneous provision, in some circumstances, the client may wish to protect its privacy and to keep others from learning that it is marketing certain properties or that it is going to be leasing in a certain area. Another client may have specific requirements for disclosing its activities or corporate policies governing the same if it is a publically traded company. Or, in certain instances, the parties may wish to make an announcement of a joint venture. To address any of these scenarios, an agreement may include a provision prohibiting disclosure of the deal (other than required by law).

A sample provision is:

> Except as required by applicable Law of any governmental body or stock exchange, neither Party may issue any disclosure or press release with respect to the transactions contemplated by this Agreement.

l. No Waiver

This provision makes clear that the failure of a party to require strict performance in one instance does not waive that party's right to insist on strict performance in the future. However, regardless of this provision's inclusion, some courts have found that the parties implicitly modified the contract through course of performance.

A sample provision is:

> No waiver of any provision of this Agreement will be deemed or will constitute a waiver of any other provision (whether or not similar), nor will such waiver constitute a continuing waiver unless otherwise expressly provided.

m. Assignment

This provision states whether the parties may assign the agreement to third parties, and if so, what is required to do so.

A sample provision is:

> Neither Party may assign or transfer any of its rights or delegate any of its duties or obligations under this Agreement without the prior written consent of the other Party, which consent will not be unreasonably withheld or delayed; provided, however, no Party, by so doing, will be permitted to increase the responsibilities or obligations, economic or otherwise, of the other Party.

n. Successors and Assigns

This provision states that the agreement is binding upon and benefits the parties' respective successors in title and in interest, legal representatives, affiliates, subsidiaries, parents, successors and permitted assigns.

A sample provision is:

> This Agreement is binding upon and inures to the benefit of the Parties, their respective successors in title and in interest, legal representatives, affiliates, subsidiaries, parents, successors and permitted assigns; provided, however, that nothing in this Section 7.07 is to be construed as an authorization or right of any Party to assign its rights and obligations under this Agreement except as provided in Section 7.06 of this Agreement.

o. Force Majeure

This provision excuses delay or inability to perform an obligation under the agreement due to certain events out of each party's control, such as natural disasters, war, and governmental actions.

A sample provision is:

> Neither Party is responsible for any failure to perform or delay in performing any of its obligations under this Agreement (including without limitation, any Schedules or Exhibits attached to this Agreement) where, and to the extent, that such failure or delay results from causes outside the reasonable control of the Party (a "Force Majeure Event"). Such causes include, without limitation, acts of God, acts of the government in either its sovereign or contractual capacity, fires, floods, epidemics, quarantine restrictions, freight embargoes, civil commotions, or the like. Notwithstanding the above, strikes and labor disputes do not constitute a Force Majeure Event. Either Party will notify the other in writing as soon as possible, but not later than 5 days after the commencement of any Force Majeure Event.

p. Survival

This provision states what terms, if any, survive expiration or termination of the agreement.

A sample provision is:

> The representations and warranties of Seller set out in Article 4 and the representations and warranties of Buyer set out in Article 5 will survive the Closing for a period of 6 months from and after the Closing Date.

q. Third Party Beneficiaries

This provision makes clear whether any person or entity, other than the parties to the agreement, have any rights or remedies under the agreement.

A sample provision is:

> Nothing expressed or referred to in this Agreement may be construed to give any person other than the Parties to this Agreement any legal or equitable right, remedy, or claim or any claim or right under any doctrines or theories of intended or third-party beneficiaries under or with respect to this Agreement or any provision of this Agreement. This Agreement and all of its provisions and conditions are for the sole and exclusive benefit of the Parties to this Agreement and their permitted successors and assigns.

8. Concluding Clause and Signature Blocks

The signature blocks are usually introduced by the concluding clause, which provides a smooth transition between the body of the agreement and the signatures. If the date of the agreement is stated in the introductory clause, use: "The Parties are signing this Agreement on the date stated in the introductory clause." In some agreements, the date in the introductory clause is defined as the "Effective Date." In that case, the concluding clause may state: "The Parties are signing this Agreement as of the Effective Date." If each signature is to be dated, then use: "Each Party is signing this Agreement on the date stated opposite that Party's signature." A signature block provides a place for the parties to sign. If the party signing is an entity, make sure that there is place for the individual signing on the company's behalf to state his or her name and title. "By:" should be listed next to the signature line to make clear that the person is not signing in his or her individual capacity. Make sure that a page break does not separate the signature blocks of the parties. If this occurs, place the signature blocks together on one page. The signature blocks may also be located together on a separate page if a signatory needs to sign in advance so that subsequent revisions do not render the signature page obsolete. Either way, there may be a large blank space at the end of the body of the contract. In that case, place the following in the blank space: "[SIGNATURE PAGE FOLLOWS]." Also, if there are multiple agreements for the parties to sign, and the signature blocks are intentionally placed on a separate page, include the name of the agreement in the concluding clause or in a notation at the bottom of the page to ensure that the signature pages are not confused.

9. Attachments

Many agreements have documents attached to the back. There are two types of attachments—exhibits and schedules.

a. Exhibits

An exhibit is a document that stands alone by itself; it is relevant to the agreement but not a part of it. It may be an existing document, such as consent resolutions previously adopted, or a document that is ancillary to the agreement and will be executed simultaneously with the agreement at the transaction closing. An example is a promissory note to be executed pursuant to a purchase and sale agreement.

b. Schedules

In contrast, a schedule is a part of the agreement. It may be a disclosure schedule containing details of ongoing litigation or lists of contracts. Or, it may consist of a large amount of information that needs to be listed, such as technical data or oil and gas leases subject to a purchase and sale agreement.

III. SPECIFIC AGREEMENTS

A. In General

An attorney is frequently sent a letter agreement in the form of a letter of intent, memorandum of intent, or terms of agreement and asked to prepare the documents that will accomplish the intent of the parties to the agreement. Frequently the client will indicate a deadline by which the agreements must be reviewed or executed by the parties. There may be considerations such as the availability of a drilling rig or lease expirations requiring the documents be signed sooner rather than later. It is extremely helpful to have some form on which to draw for purposes of expediting the preparation of the documents. Many different types of agreements are utilized within the oil and gas industry. Discussing every conceivable type of agreement is beyond the scope of this paper. However, several of the primary agreements that a client in the oil and gas business will need are discussed below.

B. Letter of Intent

This is generally the first agreement between the parties and will be used as a guide to prepare the remaining documents. There is generally an outline of the terms of the deal as agreed between the parties. A letter of intent is not always complete as to every detail of the proposed deal and the parties rely on the final documents to set out the specific terms. One issue that may arise occurs when negotiations fall though and one party declines to go through with the deal. The other party may then bring suit for specific performance or damages. The letter of intent will then be examined to determine if the terms of the letter are binding on the parties. If the parties do not wish the letter of intent to be a binding contract, the document should expressly state this intent.[14]

C. Exploration Agreements

1. In General

Also sometimes called a "joint venture," exploration agreements are one of the more flexible of the contracts used to govern the relationship of the parties in an oil and gas transaction. This is an agreement entered into between parties looking to jointly pursue an exploration project as to one or more prospects. The parties' relationship or joint venture may be governed by the exploration agreement for the entire length of the venture or only for the drilling of an initial well. The agreement may specify that all subsequent activities will be governed by an operating agreement.

2. Drafting Considerations

There is no standard form of exploration agreement. However, the agreement generally provides for a contribution of land or leases by one party in exchange for a carried interest or overriding royalty in the initial operations under the agreement. A carried interest is a fractional interest in oil and gas property, the holder of which has no personal obligation for operating costs, which are to be paid by the owners of the remaining fraction, who reimburse themselves out of production.[15] An overriding royalty is an interest in oil and gas produced at the surface, free of the expense of production; today, it usually refers to a non-cost bearing interest carved out of the lessee's working interest under a lease.[16] Among other things, the terms may provide that the carried party's burden will increase after the initial well and that all subsequent activities will be governed by an operating agreement.

Because joint operating agreements provide that one of the parties will control the operations and many exploration agreements state that the parties will share control of the operations, a conflict may arise between the two agreements. If drafting these two agreements for a client, be sure to stipulate which document will control in the event of conflict or a court may have to make that determination. For example, in *IP Petroleum Company v. Wevanco Energy*,[17] the parties first entered into a participation letter agreement (exploration agreement) and then into a joint operating agreement. A dispute arose regarding the drilling obligations in the two contracts. The court determined that the drilling obligations in the two agreements were mutually inconsistent and concluded that the joint operating agreement replaced the participation letter agreement because it was executed after the participation letter agreement.

D. Farmout Agreements[18]

1. In General

A farmout agreement is an agreement under which an owner of an oil and gas lease (the "farmor") agrees to assign oil and gas lease rights in certain acreage to another person (the "farmee") once the farmee completes its drilling obligations pursuant to the farmout agreement. Often, the lease owner (who may also be the operator) is unable or unwilling to drill on a lease but is willing to assign an interest in the lease to another operator who wants to drill on the acreage. This farmout mechanism also allows oil companies to trade for leases to put together the blocks of acreage that are necessary to develop a prospect.

There are many issues to be considered when drafting a farmout agreement, including what rights are to be earned by the farmee and the consideration that the farmor is to receive. The farmor will often retain an overriding royalty interest or a production payment. Tax considerations will also influence the structure that is used for a farmout agreement. Tax partnerships are discussed in Section IV.G. of this paper.

2. Lack of Standard Form

The terms of a farmout agreement vary greatly from deal to deal, but many are in the form of a letter agreement from the farmor to the farmee. Some of the provisions that may be included are: (i) an abandonment and takeover provision; (ii) a back-in

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[14] *John Wood Group USA, Inc. v. ICO, Inc.*, 26 S.W.3d 12, 18 (Tex. App.—Houston [1st Dist.] 2000, pet. denied).

[15] JOSEPH SHADE, PRIMER ON THE TEXAS LAW OF OIL AND GAS A-2 (3d ed., LexisNexis 2004); HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 66 (4th ed. 1976).

[16] *Id.* at A-9; *Id.* at 410.

[17] 116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. denied.

[18] *See generally*, Shade, *supra* note 15, at 104.

provision; and (iii) a preferential right to purchase or area of mutual interest provision.[19]

a. Abandonment and Takeover

The abandonment and takeover provision requires the farmee to give notice of its intention to abandon a well it is drilling or operating, and the farmor is then given a period of time to either consent to the abandonment or take over the well itself.

b. Back-in

A back-in allows the farmor to convert its overriding royalty interest into a working interest upon abandonment or payout.

c. Preferential Right to Purchase

The preferential right to purchase provision is discussed below in Section III.G.3.

3. Recent Case Law

Recent court decisions in Texas highlight the issues that may become the subject of a dispute between the parties to these agreements, some of which are discussed below.

a. Wellbore

A recent decision handed down by the Texas Court of Appeals in Amarillo interprets the definition of wellbore in an assignment granting clause.[20] Although this dispute arose in connection with an assignment made as a result of an auction of oil and gas properties, many farmouts call for the farmee to earn wellbore assignments in which the farmor will retain interests outside of the wellbore. The language of the farmout agreement and the granting clause of the assignment should be clear to as to the intent of the parties.

b. Depth Earned

The Texas Court of Appeals in Corpus Christi interpreted the language in a farmout to determine what depths were earned by the drilling of a test well. The farmout provided that the "Assignment provided for above shall be limited in depth to *100 feet below the deepest producing interval as obtained in the test well . . . .*"[21] The court interpreted the language to limit the assigned interval to the actual depth of the producing zone in the well plus 100 feet. EOG argued that it should have earned rights to the producing sand regardless of measured depth.[22] The court disagreed and EOG's interest in a second well was reduced as a result. The language in the farmout and the subsequent assignment should have referred to a producing interval by reference to an existing well and stipulated that the depths earned would include this interval in the remainder of the farmout area if that was the intent of the parties. The court found the language to be unambiguous.[23]

E. Drilling Contracts

1. In General

A drilling contract is an agreement for the drilling of a well or wells entered into between a drilling contractor, who owns drilling rigs and other equipment to drill wells, and a person or entity who owns or operates mineral rights or leasehold rights (called the "lessee" or "operator").[24]

2. Types of Drilling Contracts

There are three types of drilling contracts: a daywork contract, a footage contract, and a turnkey contract. Each type is designed to allocate risk between the drilling contractor and the operator in a different way, although daywork contracts are the most widely used. As of October 2005, daywork contracts constituted 82% of all drilling contracts within the United States.[25] This is largely due to the fact that daywork contracts are used whenever the demand for drilling is high compared to the availability of rigs.[26]

a. Daywork Contract[27]

This is a contract whereby the drilling contractor is paid a stipulated price for work performed per 24-hour day or portion thereof. In return for furnishing the drilling crew and drilling equipment, the drilling contractor is paid an agreed sum of money for each day

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[19] *See generally*, PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 432 (Abridged 3d ed. 2007).

[20] *Petro Pro Ltd. v. Upland Resources, Inc.*, 2007 WL 1717178 (Tex. App.—Amarillo June 14, 2007 pet. pending).

[21] *EOG Resources Inc. v. Wagner & Brown Ltd.*, 202 S.W.3d 338, 341 (Tex. App.—Corpus Christi 2007 reh'g overruled rev. denied).

[22] *Id.*

[23] *Id.* at 345.

[24] Williams & Meyers, *supra* note 15, at 166.

[25] Steve Berkman & Tory Stokes, 52nd Reed Hycalog Rig Census: Utilization of Rig Fleet Tightens Significantly, 226 World Oil Magazine 10 (October 2005), *at* http://www.worldoil.com/MAGAZINE/MAGAZINE_DETAIL.asp?ART_ID=2696, last visited on August 10, 2008.

[26] *See generally*, Anderson, Owen L., *Drilling for Black Gold Under the Model Form Drilling Contracts: Selecting the Type of Drilling Contract*, 15 E. MIN. L. FOUND. § 9.05 (1995).

[27] Williams & Meyers, *supra* note 15, at 132; Anderson, *supra* note 26.

spent drilling, regardless of the number of days involved. Historically, it has been viewed as more favorable to the drilling contractor since the contractor assumes less risk, and the operator assumes liability for the general risk of delay and the liabilities the contractor does not assume (the operator is willing to assume more risk because in the traditional daywork contract, the operator is in charge of day-to-day operations). However, modern forms have moved away from this and stipulate that the drilling contractor, acting as an independent contractor, is in charge of the day-to-day operations.

b. Footage Contract[28]

This is a contract between an operator and an independent drilling contractor under which payment will be made on the basis of an agreed sum per foot of hole drilled, from the surface to the agreed maximum depth. In return for furnishing the drilling crew, drilling equipment, and certain specified services, materials, and supplies, the drilling contractor is paid an agreed sum of money for each foot actually drilled, irrespective of whether the proposed depth is reached or not. In this type of contract, the drilling contractor assumes more of the general risks associated with drilling than the contractor does under a daywork contract. In general, the footage contract is viewed as more advantageous to the operator than the daywork contract because the contractor assumes more risk and the contractor is paid only for footage drilled.

c. Turnkey Contract[29]

This is a contract in which an independent drilling contractor agrees to drill to a designated depth or formation for a fixed price. In return for furnishing the drilling crew, drilling equipment, and certain specified materials and services, to be due and payable only after the hole is drilled to contract depth, the drilling contractor is paid a fixed sum of money. Of the three types of drilling contracts, the contractor assumes the most risk under the turnkey contract because the operator has general control of all drilling operations. However, turnkey contracts are often drafted to address particular drilling conditions and place specified risks on the operator. Risks assumed by the operator include risk of loss due to the operator's negligence, risk of loss of the operator's equipment, risk of loss to the contractor's equipment at times when operations are conducted on a daywork basis, and the risk of damage to the oil and gas property.

3. Specifying the Type of Contract

It may be beneficial to the drafter to clearly specify the type of drilling contract, as it may become an issue during litigation. In *Brown v. WellTech, Inc.*,[30] a drilling contractor agreed to deepen an existing well by 700 feet. The operator sued for damages after equipment was dropped down the hole during the course of drilling, and the well was lost. The contractor counterclaimed for payment of the contract price, at which point the type of drilling contract involved became an issue. The operator argued that it was a turnkey contract, and the contractor argued that it was a daywork contract because the stated consideration was for a specified rate per day. Upon remand, the court noted that a question of fact still existed as to whether the drilling contractor was entitled to compensation under the circumstances.[31]

4. Standard Provisions

A detailed discussion of the standard provisions included within each type of drilling contract is beyond the scope of this paper. However, the following is a non-exhaustive list of standard provisions generally included within drilling contracts.[32]

a. Well Description

Include the well name and legal description.

b. Commencement Date

Contractors should be aware of the risk associated with committing equipment to commence drilling a well by a certain date. If the contractor is already drilling a well for party *A* and commits to commence drilling by a certain date for party *B*, then should problems arise while drilling party *A*'s well, the contractor may be unable to commence drilling for party *B* by the date specified in the contract. This risk may be alleviated by defining the "Commencement Date" as the point in time that the drilling unit either commences jacking operations or commences pulling anchors (whichever is applicable) preparatory to moving the drilling unit to the operator's first drilling location under the contract.

c. Equipment Description

A complete equipment description should stipulate which party is responsible for providing the

[28] Williams & Meyers, *supra* note 15, at 226; Anderson, *supra* note 26.

[29] Williams & Meyers, *supra* note 15, at 616; Anderson, *supra* note 26.

[30] 769 S.W.2d 637 (Tex. Civ. App.—El Paso 1989, writ denied).

[31] Anderson, *supra* note 26.

[32] *See generally*, H. Harold Calkins, *The Drilling Contract—Legal and Practical Considerations*, 21 ROCKY MT. MIN. L. INST. 10 (1976).

equipment and what equipment is included in the prices set out in the contract.

d. Applicable Rate of Compensation

Specify the rate of compensation, including, if applicable, day work, footage rate, turnkey rate, standby time, force majeure, and the rate revision if the contract is not to be performed immediately.

e. Stoppage of Work by Operator

Typically, the contract includes a statement that the operator may order the work to stop or resume.

f. Contract Term

Be sure to stipulate the contract term, as this is particularly important in determining the end of the contract when a dispute arises between the parties.

g. Responsibility for Property Loss/Damage

Allocate the responsibility for loss or damage to the contractor's equipment, the operator's equipment, and to third party contractors' equipment.

h. Liability for Environmental Damage

Specify which party is liable for underground damage, blowouts, and pollution and contamination.

i. Indemnification and Insurance

Although indemnification and insurance requirements should be addressed as separate provisions within the drilling contract, they are discussed together because they are very much related to one another. The drafting attorney should be conscious of the interdependent nature of the indemnification, exculpatory, and insurance provisions. In general, the standard practice is for each party engaged in operations to remain responsible for its own employees and equipment and to indemnify the other party for any losses. The indemnification requirements should be supported by the appropriate amount of insurance, and the indemnitee is often named as an additional insured under the insurance policy. However, careful drafting is extremely important. In *Helmerich & Payne International Drilling Co. v. Swift Energy Company*,[33] drilling fluids spilled into a surrounding field while a contractor conducted well operations, which the operator then paid $155,000 to have cleaned up. The parties had entered into a drilling contract under which the contractor was required to maintain a Comprehensive General Liability ("CGL") insurance policy that included the operator as an additional insured. The operator made a claim for the costs incurred to clean up the spill, but the insurance company denied the claim, stating that the claim fell within the $750,000 deductible per occurrence for pollution claims. Rather than reimburse the operator, the contractor filed a declaratory-judgment suit to determine its obligations under the contract. The appeals court determined that under the drilling contract, the drilling contractor was not required to reimburse the operator even though the contract required the contractor to procure the CGL insurance and provided that all deductibles would be the sole obligation of the contractor. The court based its decision upon the fact that the indemnity provision within the contract stated that "notwithstanding anything to the contrary contained herein," the operator agreed to release, assume all responsibility for and indemnify contractor against all claims of every kind or character arising from pollution and contamination that arose during the conduct of operations.

j. Confidentiality

This stipulates that all information related to the well that is obtained by the contractor during operations (including information obtained as a result of negotiations or consultation regarding the contract) shall be held confidential by the contractor. Also, a confidentiality provision typically provides that the terms of the contract will not be disclosed publicly without consent.

k. Relationship as Independent Contractor

The modern approach in these contracts is to make clear that the drilling contractor is acting as an independent contractor.

l. "Miscellaneous" Provisions

For a discussion of various miscellaneous provisions included in contracts, see Section II.C.7. of this paper.

F. Master Service Agreements

1. In General

Master service agreements are entered into between operators and contractors (including subcontractors) to allocate risk and stipulate each party's responsibility in the oilfield.[34] It is intended to govern all future dealings between a particular operator and contractor so that the parties do not have to enter into a new agreement each time the operator issues a work order to the contractor.

[33] 180 S.W.3d 635 (Tex. App.—Houston [14th Dist.] 2005, no pet.).

[34] Stephanie K. Jones, *Negotiating the Highs and Lows in the Oil and Gas Market*, Insurance Journal (August 22, 2005), *at* http://www.insurancejournal.com/magazines/southcentral/2005/08/22/features/59582.htm, last visited on August 9, 2008.

2. Lack of Standard Form

Although sample master service agreements exist, such as the International Association of Drilling Contractors form and the master service agreement prepared by the Energy Law Committee of the Houston Chapter of the Association of Corporate Counsel, a standard form is impossible given the nature of the oil and gas industry.[35] Master service agreements differ greatly depending upon the factual scenario and are highly negotiated, especially with regards to the indemnity and insurance provisions.

3. Indemnification and Insurance

The purpose of this paper is not to discuss indemnity and insurance provisions within master service agreements. However, the drafting attorney should be aware that in general, a master service agreement requires the contractor to indemnify the operator against any and all claims arising out of or in connection with the services and materials supplied by the contractor, regardless of whose negligence causes it. Typically, contractors are also required to carry minimum amounts of insurance coverage and to include the operator as an additional insured.[36] (Note, however, that an anti-indemnity statute may apply. See Section IV.E.2. of this paper for a further discussion of anti-indemnity statutes.)

If representing the indemnitor, it is suggested that a limitation should be included as to both the amount of the indemnification obligation and the time period under which the indemnification obligation lasts. For example:

> Notwithstanding anything contained in this Agreement to the contrary, the indemnification obligations of the Parties, regardless of whether one or more Claims are asserted, shall be limited to an aggregate amount equal to the fees actually paid to XYZ Corporation under this Agreement. Furthermore, the indemnification obligations in this Paragraph 6 shall survive for a period of one year after this Agreement terminates.

G. Joint Operating Agreements

1. In General

The American Association of Petroleum Landmen (A.A.P.L.) Form 610 – Model Form Operating Agreement (the "JOA") is possibly the most used form of agreement by partners in oil and gas operations. The JOA is the industry standard governing operations of oil and gas properties by domestic on-shore companies. The forms are generally known by the year of adoption and the most prevalent are the 1982 and the 1989 forms. There are many operating agreements still in use that have been in effect since the 1940s and earlier. When preparing the JOA keep in mind that there may be landmen and attorneys in fifty years trying to apply the terms of the prepared JOA.

The JOA generally contains the following information and provisions: (i) describes the lands covered by the JOA; (ii) names the operator; (iii) sets out the duties and obligations of the operator and non-operator; (iv) provides for removal of the operator; (v) governs drilling of an initial well; (vi) governs operations of that well; (vii) governs the drilling of subsequent wells; and (viii) attempts to address the consequences to the parties of default by a partner, bankruptcy, dry holes, loss of leases, and many other activities that may take place between the parties during the term of the JOA. All of the previous provisions are fraught with the possibility of misinterpretation when a contract is not clearly drafted. One of the pitfalls of using any model form is that the drafter will fail to complete a section or will not change a particular provision to conform to the current agreement. It is essential to familiarize oneself with the provisions of the JOA and its exhibits in order to draft the document that the client requires.

The most flexible part of the form itself will be Article XVI, or "Other Provisions," where other terms of the JOA may be elaborated upon or changed. It should include a conflict of terms section that provides that the Article XVI provisions prevail over other provisions in the JOA. Recent case law in the jurisdiction where the client operates should be studied before drafting the JOA. The following will illustrate some of the current issues that should affect discussions with a client as to the implications of the provisions selected. (Note that there are also model forms for offshore and deepwater operations to which these comments will also apply.)

2. Maintenance of Uniform Interest

Under JOA Article VIII, Acquisition, Maintenance or Transfer of Interest (the "MOI"), many operators will strike the preferential right to purchase section in order not to be restricted in selling or assigning an interest in a property, however the same operator may not consider the ramifications of Section D. Assignment: Maintenance of Uniform Interest. In

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[35] Donald P. Butler, *Beyond the "Knock" in Oilfield Master Service Agreements: Limiting Risk in the Rest of the MSA with a Complete Form*, 2004 Rocky Mtn. Min. L. Inst. Paper No. 10B.

[36] Redfearn, Robert, Jr., *Oilfield Anti-Indemnity Acts and Their Impact on Insurance Coverage*, Insurance Journal (August 22, 2005), *at* http://www.insurancejournal.com/magazines/southcentral/2005/08/22/features/59583.htm, last visited on August 9, 2008.

ExxonMobil Corp. v. Valence Operating Co., 174 S.W.3d 303 (Tex. App.—Houston [1st Dist.] 2005, pet. denied.), the court interpreted the MOI provision of an operating agreement to mean that ExxonMobil could not farm out a portion of a lease despite modifying the provision; in this case, ExxonMobil had farmed out its interest in only one formation and Valence, one of ExxonMobil's partners, sued stating that the MOI had been violated by the farmout.[37] The provision in the JOA read as follows:

> Maintenance of ~~Uniform~~ Interest:
>
> ~~or the purpose of maintaining uniformity of ownership in the oil and gas leasehold interests covered by this agreement, and~~ Notwithstanding any other provisions to the contrary, no party shall sell, encumber, transfer or make other disposition of its interest in the leases embraced within the Contract Area and in wells, equipment and production unless such disposition covers either:
>
> 1. the entire interest of the party in all leases and equipment and production; or
>
> 2. an equal undivided interest in all leases and equipment and production in the Contract Area.
>
> Every such sale encumbrance, transfer or other disposition made by any party shall be made expressly subject to this agreement, and shall be made without prejudice to the rights of the other parties.[38]
>
> (Strikeouts in original.)

The court said: "The intent of the parties in including the MOI provision in the JOA was to ensure that any party's conveyance of an interest under the lease conveyed either the party's entire interest or an equal undivided interest in all leases and equipment and production in the contract area. In short, the MOI provision evinces the intent of the parties not to partition the undivided interests in the leases."[39] This may not have been the original intent of the parties when the agreement was signed, but the court's interpretation of the provision meant that the effect was the same as if the provision had not been modified.

3. Preferential Right to Purchase [40]

"A PRP has been defined as a right reserved by a party to a farmout or other agreement to buy the interest of the other party, provided it is willing to pay for such interest at a price which is offered therefor in good faith."[41] Should a client wish to have this provision in the JOA, some recent case law should be reviewed. There may be many pitfalls in this provision.[42]

a. Notice

For a review of the consequences of inadequacy of notice under a preferential right to purchase see *McMillan v. Dooley*, 144 S.W.3d 159 (Tex. App.—Eastland 2004, pet. denied). This decision related to three oil and gas leases and three lawsuits that were consolidated into one case. The Eastland Court of Appeals held that in one of the three cases a preferential right to purchase expired because it was not timely exercised.[43] In this instance, the holder of the preferential right did not affirmatively assert the intent to exercise the preferential right but instead made what the court interpreted to be a counter-offer to the preferential right letter.[44] The court said the ten day period for exercising the right to purchase the property expired without acceptance by the plaintiff.[45] If the preferential rights provision had been drafted to specify the terms to be disclosed to the other party, the plaintiff might not have lost his right. If the plaintiff had unconditionally stated his intent to exercise his preferential right to purchase, and also requested additional information concerning the terms of the proposed sale, then the court might have found in his favor and he could have kept the right alive. It is important that the language of the preferential right be drafted with clarity. If the client is preparing to exercise a preferential right to purchase, it is essential to follow the terms in the agreement.

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[37] *ExxonMobil*, 174 S.W.3d at 314.

[38] *Id.* at 311.

[39] *Id*. at 314.

[40] *See* Arnold J. Johnson, *The Preferential Right to Purchase in the Texas Oil Patch*, presentation to the Houston Association of Lease and Title Analysts, July 18, 2000 (on file with author) for an excellent discussion of this topic.

[41] *Id.* (citing *Lulig Oil & Gas Co. v. Humble Oil & Ref. Co.*, 191 S.W.2d 716 (Tex. 1945) and H. WILLIAMS AND C. MEYERS, MANUAL OF OIL AND GAS TERMS (10th ed. 1997)).

[42] Johnson, *supra* note 40.

[43] *McMillan v. Dooley*, 144 S.W.3d 159, 181 (Tex. App.—Eastland 2004, pet. denied).

[44] *Id.* at 179–80. Plaintiff Dooley declined to accept additional properties listed in the preferential rights notice from defendants, and therefore was deemed by the court to have made a counter-offer. *Id.* at 176.

[45] *Id.* at 180.

b. Interests Subject to a Preferential Right to Purchase

A decision from the Texas Court of Appeals in Dallas found that an overriding royalty reserved in a farmout agreement was subject to the preferential right to purchase provision contained in the JOA executed at the same time, an outcome not necessarily foreseen by the parties to the farmout. [46]

4. Policies

The following provisions may be included in different types of energy industry agreements, including a JOA. The decision as to which of these provisions to include within an agreement will depend on the policies of the client. Some provisions will be included because they are regulatory requirements. The drafter should ensure that if a law or regulation is cited in the provision that it is the most current version.

a. Contraband

A statement of the company's policies regarding possession of illegal drugs, or possession of firearms by employees, contractors, or sub-contractors on a job premises, particularly at a drill site (onshore or offshore) may be included. Note that a regulatory authority may require the inclusion of this provision.

b. Non-Discrimination and Certification of Non-Segregation of Facilities

Regulatory authorities may also require inclusion of a statement by the parties that they are in compliance with various government regulations, such as the rules promulgated by the Department of Labor and the Department of Health, Education and Welfare.

c. Safety

The client may also wish to include a statement of the company's policies regarding safety in the work place, or this may be required to comply with governmental regulations.

H. Confidentiality Agreements

A confidentiality agreement is drafted primarily to protect a client's proprietary information from misuse by an outside party and may be created for different situations or transactions. Reasons for including a confidentiality agreement in a deal may be to protect information acquired while evaluating a prospect, another for a sale of assets, or a third for a prospective partner.

1. Avoid Broad Language

The agreement should be drafted to avoid broadness by specifying what exactly is to be held confidential. That is, a definition of what information is to be considered confidential should be included in the agreement.

2. Who Should be Covered

The drafter should consider the persons allowed access to the confidential information. If consultants, legal advisors, or employees of affiliates are to be covered by the agreement, this should be specified. It is a good idea to specify in the agreement that consultants are covered by the agreement and to define the term consultant. Otherwise, the other party may call non-employees consultants, and there is a risk that this individual uses the client's confidential information without the client having any kind of remedy.

3. Non-Confidential Information

The agreement should also specify what information is not confidential, such as information that is readily available to the public.

4. Disclaimer of Accuracy of Information

If representing the party that will be disclosing the confidential information, then the agreement should include a provision disclaiming the accuracy of the information and limiting the disclosing party's liability for the receiving party's use of the information. For example:

> The Disclosing Party makes no representations or warranties, express or implied, as to the quality, accuracy, and completeness of the Confidential Information disclosed pursuant to this Agreement, and the Receiving Party expressly accepts the Confidential Information without any warranties or representations whatsoever and without recourse against the Disclosing Party. The Disclosing Party, its Affiliated Companies (as defined below), their officers, directors, and employees have no liability whatsoever with respect to the Receiving Party's use of, or reliance upon, the Confidential Information.

5. Standard of Care

Many confidentiality agreements, or confidentiality provisions within other agreements, simply state that a party must hold the other party's confidential information "strictly confidential." What does "strictly confidential" mean? Does the receiving party have to lock up the information? Is simply marking it "confidential" and filing it in a box sufficient?

To prevent potential disputes, the agreement should stipulate the standard of care each party should

[46] *El Paso Prod. Co. v. Geomet, Inc.*, 228 S.W.3d 178 (Tex. App.—Dallas 2007, reh'g overruled).

use to ensure that the other party's confidential information is kept confidential. A good standard to incorporate into the agreement is that the receiving party will use the same standard of care for the disclosing party's information that the receiving party uses to control its own information. The following is an example of the language that may be used to define the standard of care:

> Any Party who receives confidential information, data, or proprietary rights of the other Party (collectively, the "Disclosing Party's Confidential Information") shall use at least the same degree of care to safeguard and to prevent the disclosure, publication, dissemination, destruction, loss, or alteration of the Disclosing Party's Confidential Information as the receiving Party employs to avoid unauthorized disclosure, publication, dissemination, destruction, loss, or alteration of its own confidential information, data, or proprietary rights of a similar nature, but in no case less than reasonable care.

6. Term

All confidentiality agreements (and provisions) should include a term so that the parties' obligations do not last indefinitely. The term is usually somewhere between one to five years after the date of the agreement. Upon termination of the agreement, the receiving party should have a duty to return or destroy all information that it received.

7. Disclosing the Existence of an Agreement

Some confidentiality agreements include a provision restricting the parties' ability to disclose the fact that the agreement even exists. For example:

> The Receiving Party agrees that, without the prior written consent of the Disclosing Party, the Receiving Party and its representatives will not disclose to any person the fact that the Evaluation Material has been made available to the Receiving Party, that discussions or negotiations are taking place concerning a possible acquisition of the Properties or any of the terms, conditions or other facts with respect thereto, including the status thereof. The term "person" as used in this Agreement shall be broadly interpreted to include the media and any corporation, partnership, group, individual or other entity.

Although this provision seems reasonable, it may prove to be problematic for the client if, subsequent to the execution of the confidentiality agreement but before the confidentiality agreement terminates, the client enters into an agreement with a third party that requires disclosure of all material contracts. As written, one could argue that the provision above precludes the client from even disclosing the existence of the confidentiality agreement. To prevent this from becoming an issue, the confidentiality agreement should include language that allows the parties to disclose the fact that the confidentiality agreement exists without disclosing the parties or the details of the transaction.

IV. SPECIAL CONSIDERATIONS

A. In General

Drafting agreements when a client is an international entity or dealing with an international entity will require familiarity with some federal statutes. Doing business out of state may also require additional attention to regulations. Below are some issues to consider, particularly in acquisitions.

B. Qualifying to Conduct Business as a Foreign Entity

If the client will engage in oil and gas operations in a state other than the state of its formation, then the client will have to meet certain requirements before it may conduct business in that state.

1. Secretary of State

All "foreign" entities (entities not formed under the laws of the state where it wishes to conduct business—for example, a Louisiana corporation is a foreign entity in Texas) must qualify with the state's Secretary of State prior to conducting any business in that state. This qualification (or registration) requires filing certain documents with the Secretary of State, and each state will have its own requirements.

2. Oil and Gas Regulation

If the business that will be conducted by the foreign entity is oil and gas related, there may be separate and additional requirements that must be met before any operations may commence. Qualifying to operate oil and gas wells is governed by the laws of the state in which the wells are located, and the lawyer should ensure the client is qualified in advance of a transaction in a state where the client has never operated.

C. Hart-Scott-Rodino

The Hart Scott Rodino Antitrust Improvements Act of 1976[47] (the "Act") was adopted to provide the federal government with the opportunity to review the potential effects on competition of certain mergers, acquisitions or other consolidations that meet the Act's

[47] 15 U.S.C.A. § 18a (West 2008).

criteria for size of a person or transaction tests. The parties to an agreement must file notifications with the Federal Trade Commission and the Antitrust Division of the Department of Justice. The agencies have a 30 day period to review or request further information from the parties. The parties may not close a transaction prior to the end of this period. Any transaction subject to the requirements of the Act should be reviewed by someone very familiar with the provisions of the Act.

D. Exon-Florio

The full title of the bill is the Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988[48] or the Foreign Investment and National Security Act of 2007 ("FINSA"). FINSA amended the Defense Production Act of 1950 to codify review of foreign investments by the Committee on Foreign Investments in the United States ("CFIUS"). The law was intended to provide for an investigation or review of proposed foreign investments in the United States in order to restrict any direct foreign investment that threatens national security.[49] The statute defines a covered transaction as "any merger, acquisition or takeover that is proposed or pending after August 23, 1988, by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States."[50]

E. Area of Operations

1. Onshore or Offshore

The drilling of onshore wells, unless on federal lands, is generally governed by the requirements of the state agencies having the charge to regulate the energy industry. As discussed above, the qualification of a company to operate oil and gas wells will be governed by the state agency in charge of the regulatory scheme. Ensure that the client has complied with all requirements if it is a new venture for them.

2. State Specific Provisions

There are also jurisdiction specific differences that should be considered when drafting documents. If the client has operated in one state and decides to begin operating in another state, they should be made aware of these differences. Some statutory schemes in Louisiana and Texas that reflect some of these differences are discussed below.

a. Texas and Louisiana Oilfield Anti-Indemnity Acts

The Oilfield Anti-Indemnity Acts apply to provisions contained in any agreement pertaining to oil and gas wells. The two statutes are similar in their intent to prevent shifting the burden of defense or indemnification caused by negligence if there is negligence or fault on the part of the indemnitee or its agents, employees or independent contractors causing the death or bodily injury to persons.[51]

(1) Louisiana

Under the Louisiana Oilfield Anti-Indemnity Act ("LOAIA"),[52] contractual indemnity "provisions in oilfield contracts are void and unenforceable to the extent that they provide for indemnification for losses caused by the negligence or fault of the indemnitee." [53] However, the Fifth Circuit found a narrow exception to the Act that permits indemnification for a party's own negligence so long as the indemnitee procures and pays for the insurance coverage itself.[54] LOAIA does not affect the validity of any insurance contract, except as provided for in the Act. Certain contracts, such as farmout agreements and joint operating agreements are specifically excluded from the Act. Louisiana has no express insurance restriction in LOAIA. No insurance limitations are mentioned in the statute if an indemnification is allowed, however the source of payment for the insurance premiums was the deciding factor in the court disallowing an insurance policy in *Amoco Production Co. v. Lexington Ins. Co.*[55]

(2) Texas

The Texas Oilfield Anti-Indemnity Act was passed in 1973 ("TOAIA")[56]. One of the reasons for the prohibition of certain indemnity agreements is contained in Section 127.002 of the Texas Civil

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[48] 50 U.S.C. app. § 2170 (2000).

[49] United States Department of the Treasury, Office of Foreign Affairs, Committee on Foreign Investment in the United States (CFIUS), at http://www.treas.gov/offices/international-affairs/exon-florio/, last visited on August 10, 2008.

[50] 50 U.S.C. app. § 2170 (a)(3) (2000).

[51] *See* J. Lanier Yeates, *Indemnification and Anti-Indemnity Statutes as they Related to Mineral Rights and Contracts*, 33 MIN. LAW INST. 110 (1986) and J. Lanier Yeates, *An Update on Anti-Indemnity in Louisiana and Texas – Indemnification and Anti-Indemnity Statutes – Part II*, 38 MIN. LAW INST. 443 (1991) for a detailed discussion of these issues.

[52] LA. REV. STAT. ANN. § 9:2780 (West 1991 and Supp. 2002).

[53] *Patterson v. Conoco, Inc.*, 670 F. Supp. 182, 183 (E.D. La. 1987).

[54] *Marcel v. Placid Oil Co.*, 11 F.3d 563, 569 (5th Cir. 1994).

[55] 745 So.2d 676, 680-81 (La. App. 1st Cir. 1999).

[56] TEX. CIV. PRAC. & REM. CODE ANN. §§ 127.001–.007 (Vernon 2005).

Practice and Remedies Code, which states that it is against public policy to allow indemnification of a negligent indemnitee. Texas does allow indemnity agreements under the Act if the indemnities are mutual. Texas allows any amount of insurance for mutual indemnities as long as the amount is the same for both parties, but restricts the amount to the least insurance coverage. TOAIA expressly restricts the amount of unilateral coverage to $500,000.00.

b. Texas and Louisiana Oil Field Lien Acts

These are statutory schemes concerning the ability of contractors to file liens for work done on wells. Although these Acts may not affect how an agreement is drafted, one should be aware of how this type of lien (or privilege) may affect title to properties the client may be acquiring.[57]

(1) Louisiana

The Louisiana Oil, Gas and Well Lien Act grants a privilege to persons who perform services or provide materials connected to operations.[58]

(2) Texas

The Texas Oil Well Lien Act grants to a mineral contractor or subcontractor a lien to secure payments for labor or services related to the mineral activities.[59]

F. Stock Exchange Requirements

If the client is a publicly traded company, and particularly if the company or parent is a non-domestic company, the drafting attorney should be aware of any legal requirements concerning filings or announcements. Publicly traded domestic companies must comply with Securities and Exchange Commission requirements. These companies should have financial advisors who will determine the disclosure requirements for sales, acquisitions, stock deals and other such agreements.

G. Tax Partnerships

1. Generally

In drafting trade agreements, determine whether the parties to a trade agreement wish to be considered as partners for income tax purposes. Familiarity with the implications of tax partnerships in the oil and gas industry is frequently limited to the trade documents attorneys may draft in which a client elects whether or not to create a tax partnership. In the 1989 AAPL Model Form Operating Agreement, for instance, this election is made under Article IX as a default exclusion from the application of Subchapter K of Ch. 1 of Subtitle "A" of the Internal Revenue Code. If the parties to the agreement decide to form a partnership, an additional Exhibit is included in the Operating Agreement. The attorney should advise the client to consult a tax specialist unless he or she is qualified to provide this type of in-depth tax advice.

2. Pool of Capital Concept

Even attorneys who are not tax specialists should become aware of the "Pool of Capital Concept" in which parties each contribute goods or services to a deal. Older cases governed treatment of farmouts under the Pool of Capital concept. This concept originated in a case decided the Supreme Court in 1933, *Palmer v. Bender*, 287 U.S. 551 (1933), in which it was decided that no taxable income resulted from the contribution of goods or services toward the development of a mineral property in exchange for an interest in the property. The parties agreed to an exchange of acreage for the service of drilling the well. One party contributed leases and the other party labor, thus no taxable income resulted from the trade. This is the basic set up of a farmout agreement.

3. Revenue Ruling 77-176[60]

Note that a taxable event may be created by a farmout agreement in which one party contributes land and another party contributes drilling expertise, for the farmor and for the farmee, when the land earned under the farmout is more than the drill site. Being familiar with the consequences of Revenue Ruling 77-176 and Revenue Ruling 83-46 (which governs treatment of overriding royalties earned for services rendered) can assist in understanding the issues that should be considered prior to making a decision whether to create a tax partnership for income tax purposes.

4. Louisiana

Note that in Louisiana, a written contract for the joint exploration, development, or operation of mineral rights does not create a partnership unless the contract expressly provides for creation of a partnership.[61]

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[57] *See* Patrick H. Martin and J. Lanier Yeates, *Louisiana and Texas Oil & Gas Law: An Overview of the Differences*, 52 LA. L. REV. 769 (1992).

[58] LA. REV. STAT. ANN. §§ 9:4861–4873 (West 2007).

[59] TEX. PROP. CODE ANN. §§ 56.001–.003 (Vernon 2007).

[60] Rev. Rul. 77-176, 1977-1 C.B. 77.

[61] *See* J. Lanier Yeates, *Differences of Importance in the Laws of Louisiana and Texas for Energy Lawyers*, presentation to the Dallas Bar Association, August 1991 (on file with author) (citing LA. REV. STAT. ANN. §31:215).

V. FINAL THOUGHTS

A. Updating Existing Provisions and Older Agreements

If using older agreements or existing provisions (such as those in a miscellaneous provisions database) as a starting point to prepare new documents, it is imperative to update these agreements and provisions so that they conform to existing law and standard industry practice. The provisions most likely susceptible to changes in the law are exculpatory, indemnity, and insurance provisions. Failure to keep abreast of current legislation and case law could result in unintended negative consequences for the client.

B. Conclusion

Preparing "form" agreements for clients within the oil and gas industry does not have to be complex, especially if the attorney has prepared a basic form that may be elaborated upon and specially adapted to the client's particular needs. All well drafted agreements share common elements. The key to preparing a forms library for a client within the oil and gas industry is to utilize these elements while simultaneously incorporating standard provisions contained in agreements typically used in the energy industry.