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Can Stapling Create Harmony: The JOA and the COPAS Accounting Procedure

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Can Stapling Create Harmony: The JOA and the COPAS Accounting Procedure

Presented by:
Susan R. Richardson

Lore v. Law

- Lore - Traditional knowledge or belief (real world)
- Law – Constitutional, statutory, and common law (courthouse)

Ten Things You Ought to Know About
COPAS/JOA but Were Never Remotely
Interested in Asking

10. Relationship of the Parties under the JOA

9. Applicability of Exculpatory Language to Accounting Activities

8. Statute of Limitations: 24 months or 5 years

7. Use of COPAS Bulletins or Interpretations; now, Advisory Guidelines (AG’s) or Model Form Interpretations (MFI’s)

6. Timing of an Audit and Audit Protocol

5. Overhead and Direct Charges

4. Material Purchases

3. Affiliates

2. Ecological, Environmental, Safety

1. Mediation, Arbitration, Litigation

Relationship of the Parties [p. 1-3]

1956 Form, 1977 Form, and 1982 Form

- Do not specifically negate agency
- Do not specifically negate fiduciary relationship
- Do not call the Operator an independent contractor
- Do not specifically obligate the parties to act in good faith

These forms do require:

- Good and workmanlike conduct

Relationship of the Parties [p. 1-3]

1989 JOA Form

- Operator acts as an independent contractor
- Not an agent, not a fiduciary
- Should operate:

(1) In a good and workmanlike manner

(2) With due diligence and dispatch

(3) In accordance with good oilfield practice

(4) In compliance with applicable law and regulation

(5) Parties should deal in good faith

Relationship of the Parties [p. 1-3]

But see: *Texas Oil and Gas v. Hawkins* [p. 2]

HELD: Relationship of Trust and Confidence between Operator and Non-Operator when Operator acquired replacement leases in Operator's sole name.

TRIGGER: Execution of a Joint Operating Agreement

Standard of Care [p. 3-6]

- 1982 JOA – "____shall be the Operator of the Contract Area, and shall conduct and direct and have full control of all
  - Operations on the Contract Area
  - It shall conduct all such operations in
    - (a) ". . . In a good and workmanlike manner. . . "
    - (b) "but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct."

Standard of Care [p. 3-6]

- 1989 JOA –
  - (a) "Operator shall conduct its activities under this agreement as a reasonable prudent operator . . ."
  - (b) ". . . in a good and workmanlike manner"
  - (c) ". . . with due diligence and dispatch"
  - (d) "in accordance with good oilfield practice"
  - (e) ". . . And in compliance with applicable law and regulation"
  - (f) ". . .but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct."

1982 JOA - COPAS

- Exculpatory Language does not apply to breaches of the express provisions of the operating agreement e.g. COPAS as opposed to improper operations on the contract area.
  - *Abraxas v. Hornburg (2000)*
  - *Cone v. Fagadau (2002)*
  - *Castle Prod. L.P. v. Long Trusts (2003)*

1982 JOA - COPAS

- ***Contra***
  - ***Stine v. Marathon Oil Co. (5th Cir. 1992)***
- This protection [exculpatory language] extends to Marathon’s various administrative and accounting duties including
  - The recovery of the costs under the authority of the JOA”

1989 JOA - COPAS

- Apparently all activities to be judged by exculpatory language limiting liability to Operator's gross negligence and willful misconduct
- Significance:
  - Not mere breach of contract standard re: breach of COPAS provisions
  - Heightened tort standard: Gross Negligence or Willful Misconduct

What is Gross Negligence?

- Depends on the definition of the term at the time the parties entered into the contract
- ***Smith v. Elliott & Deats***: “laws which subsist at the time and place of the making of a contract . . . Enter into and form a part of it, as if they were expressly referred to or incorporated in its terms.” (Tex.Sup. 1873)

What is Gross Negligence?

- Gross negligence means an act or omission:

  (a) . . .when viewed objectively . . . Involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others, and

  (b) of which the actor has actual, subjective awareness . . . But proceeds with conscious indifference to the rights, safety, or welfare of others . . ."

What is Willful Misconduct?

"Willful misconduct" is intentional or wanton conduct in doing or omitting to perform acts, with knowledge or appreciation of the fact, on the part of the culpable person, that danger is likely to result therefrom.

Steward v. Thomas, 222 Ark. 849, 262 S.W.2d 901 (1953)

Observations

(a) Gross negligence and willful misconduct should not be a standard that applies to breaches of the COPAS accounting procedure

(b) Operators need protection from mere judgment errors but not from contract breaches

(c) 2005 Procedure:

Damages and losses [to third parties] chargeable to Joint Account except to the extent caused by a Party's gross negligence or willful misconduct

Recommendation

The AAPL and COPAS need to form a joint committee whose mission would be to agree on a standard of care involving not only operational issues but administrative and accounting issues that will be fair to Operators and Non-Operators alike. The current forms include language which are a disservice to the industry.

Statute of Limitations on COPAS Breaches [p. 16-19]

- Did you raise an exception in 24-month window?
- Breach of written contract – 5 years statute of limitations
- Fraud – 3 years statute of limitations

If exception is not timely made, the charges are presumed to be “conclusively true and correct”

LESSON: (1) Need to complain in the 24-month window
(2) Need to file suit within 5 years

Prior COPAS Models [p. 24-25]

- Use of COPAS Interpretations/Bulletins in Resolving Audit Exceptions and at trial
  - Standard in the industry to use these as guidelines when taking exception (Lore)
  - Probably inadmissible at trial unless the court finds a particular provision of the COPAS is ambiguous
  - ". . . Parol evidence cannot be received of a custom or usage which will change the plain meaning of the words or phrase used in the instrument" ***Iowa v. F.S. Ainsa***

New 2005 COPAS

- Significant references to Advisory Guidelines and Model Form Interpretations
- AG-19 – Audit Protocol
- AG-24- Obtaining approval of accounting procedure exceptions
- MFI-46-Shore base facilities and offshore staging areas
- MFI-27-Employee benefits chargeable to joint operations and subject to percentage limitations

Modification of Accounting Procedure [p. 6-8]

- The Accounting Procedure can be modified by conduct if not enforced
  - ***Hondo Oil & Gas v. Texas Crude Operator, Inc.***
  - Operator sent out letter saying it was switching from PASO to COPAS Accounting Procedures
  - Some non-operators complained (Amoco) and were kept under the old agreement

Modification of Accounting Procedure

- ARCO did not complain, continued to receive and pay JIB's under the new accounting procedure
- Court held that since the proof was that ARCO was paying no more than its proportionate share of costs, the fact that Amoco was paying less than its proportionate share did not prevent the Operator from operating under two separate accounting procedures.

Recommendation

- If the Operator is engaged in charging inconsistent with the COPAS, take exception even if no litigation is contemplated. Otherwise, the charges will be “presumed true and correct” and an action to secure a finding of breach will be lost.

Timetable of Audits [p. 12-15]

- 1984 COPAS –
  - Need to take exceptions within 24 month window (or "charges shall conclusively be presumed to be true and correct").
  - No specific format for audit exceptions except they must be "written" and there must be a "claim for adjustment."
  - No timetable for Operator to reply.

Timetable of Audits [p. 12-15]

- 1995 COPAS
  - Same 24 month window for exceptions
  - 180 days for auditors to issue report after completion of the audit field work
  - 180 days for Operator to respond to allow or deny exceptions
  - 90 days for auditor to reply to Operator's response
  - 90 days for Operator to respond to reply

- 2005 COPAS
  - Same 24 month window
  - Audit report issued within 90 days after completion of the audit testing
  - A timely filed audit exception precludes the Operator from asserting a statute of limitations defense against such claims
  - If the non-operators miss later deadlines, the Operator’s waiver of its rights shall lapse
  - Audits are to be conducted under AG-19 (Expenditure Audits in the Petroleum Industry)

- 180 days for Operator to respond (response must be substantive) (if no substantive response, Operator will owe interest)
- 90 days for auditor to reply to Operator's response
- Operator may call a "resolution meeting" if audit issues are not resolved after 15 months
- Any non-operator who fails to attend the resolution meeting will be bound by whatever agreement is reached at the meeting
- If "resolution meeting" does not work, then the dispute shall be submitted to mediation

Overhead [p. 11-12]

- 1984 COPAS—as compensation for administrative, supervision, office services and warehousing costs, Operator shall charge drilling and producing operations on either: Fixed Rate Basis or Percentage Basis.

Overhead

- “Salaries and personal expenses of Technical Employees and/or the cost of professional consultant services and contract services of technical personnel directly employed on the Joint Property: shall be covered by the overhead rates or not” [Election for the parties to make]

Overhead

- Joint Property is defined as: the real and personal property subject to the agreement to which the Accounting Procedure is attached.
- Rates can be adjusted based on the Crude Petroleum and Gas Production Workers Index published by the Dept. of Labor **[Now no longer published] (If your old agreement references this index, you need to change it.)**
- Oil and Gas Extraction Index blended with the Crude Petroleum and Gas Production Workers [New Index]

Solution

- Per the voting provision in I(6) of the COPAS, the majority can vote to amend the agreement to adopt the new index (unless prohibited by the Operating Agreement)

Direct Charges

- 1995 COPAS
  - Requires that technical employees be “employed on the Joint Property” to be directly chargeable.
  - Also required that benefits, expenditures made pursuant to assessment imposed by governmental authority, travel, and government mandated training be paid for plus any established plan as dealt with in the COPAS Interpretation No. 11

Direct Charges

- 2005 COPAS
  - Technical employees must be performing day-to-day operations on the joint property and who report directly to the individual performing the first level supervisor function
  - Allows use of allocation system instead of time chart
  - Relies on MFI-37 (Incentive Compensation Damages)

2005 COPAS – Other Direct Charges

- Defines “on-site” and “off-site” and provides that field employees on site can be direct charged
- Provides for charges for facilities that “serve” the Joint Property under certain circumstances
- Provides for technical employees that are providing off-site services if such charges are excluded from the overhead rates but only until the specific operating condition or problem is solved

2005 COPAS

- Allows Operator to calculate a “day rate” for employees representing the Operator’s average salaries and wages of the employee’s specific job category
- Allows holidays, vacation pay, etc. plus “reasonable” relocation expenses, and training costs as specified in COPAS MFI-35, costs of benefit plans in COPAS MFI-27, and Award payments to employees in accordance with COPAS MFI-49

Material Purchases [p. 19-20]

- Computerized Equipment Pricing System (CEPS)
- COPAS Historical Price Multiplier [HPM]
- Price Quotation from a Vendor that reflects “current realistic acquisition cost”
- Amount paid by the Operator within the previous twelve (12) months from the date of physical transfer

Affiliates [p. 20-21]

- 1984 COPAS
  - Not defined and not mentioned – therefore no prohibition and no contractual restriction on their use.
- 1995 COPAS
  - Defined as any party directly or indirectly controlling, controlled by, or under common control with the Operator

2005 COPAS

- Affiliate defined as “a person, another person, that controls, is controlled by, or is under common control with the person. Control means the ownership by one person directly or indirectly of more than 50% of the voting securities of a corporation or, for other persons, the equivalent ownership interest such as partnership interest and “person” means an individual, corporation, partnership, trust, estate, unincorporated organization, association or other legal entity.

- How used?
  - Amalgamates affiliates for voting procedures treating them as a Single Party
  - For use of an Affiliate’s goods and services requiring an AFE, an Affiliate can be used as long as they are identified, and the goods and services are specifically detailed in the AFE and the total costs for such goods and services does not exceed $_______(TBD by the parties)

Affiliates

- Charges to the Joint Account shall not exceed average commercial rates for such services
- Allows the parties to vote whether the records relating to the work performed by Affiliates will not be made available for audit

- For use of an Affiliate's goods and services where no AFE required, charges for such goods or services shall require approval of the Parties if the charges exceed $______in a given calendar year.
- Costs must not exceed commercial rates prevailing in the area of the Joint Property.

Ecological, Environmental, Safety

- Costs of off-site technical services chargeable if required
- Costs of off-site technical services covered by overhead if not required

- Mediation
- Arbitration
- Litigation (or how did you plan to spend the next five years?)

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Susan R. Richardson

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WILL STAPLING CREATE HARMONY?
OR
THE ART OF RECONCILING THE JOA AND THE COPAS

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WILL STAPLING CREATE HARMONY?
OR
THE ART OF RECONCILING THE JOA AND THE COPAS

I. The Operating Agreement

Introduction

The framework of operations for oil and gas properties by more than one leasehold owner is typically a more or less standardized form known as the Joint Operating Agreement. The attempts at standardization have led to the creation of the A.A.P.L. Form 610 Model Form Operating Agreement ("JOA"). The most recent form of that agreement is the 1989 version, preceded by the 1956, 1977 and 1982 form. Normally, one of the exhibits attached to the Joint Operating Agreement is a document called "Accounting Procedure Joint Operations." The current most widely used form attached to the JOA is the 1984 Onshore Council of Petroleum Accountants Societies' (COPAS) Accounting Procedure, which outlines the basics of accounting among the co-owners in an oil and gas venture. There was a new version of the COPAS Accounting Procedure published in 1995 although the 1995 version was not intended by COPAS to replace the 1984 and 1986 forms. In 2005, the newest version of the COPAS accounting procedure was introduced and adapted by COPAS in April of 2005. The objectives of the 2005 versions were to update the terms, incorporate standards from COPAS interpretations, provide flexibility for a variety of users and operations, minimize exception accounting and encourage industry use and acceptance. This paper will analyze the issues raised by the attempted merger of the form JOA and the form Accounting Procedure, and litigation issues arising therefrom.

A. Relationship of Parties under the Operating Agreement.

1. The Language of the Model Forms

Article V(A) in the 1956 Form, 1977 Form and the 1982 Form states:

> "[ABC Oil Company] shall be the operator of the Contract Area and shall conduct and direct and have full control of all <u>operations</u> on the <u>Contract Area</u> as permitted and required by, and within the limits of this agreement. It shall conduct all <u>such operations</u> in a good and workmanlike manner but it shall have no liability as operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct" (emphasis supplied).

By way of contrast, consider the language of Article V(A) in the 1989 Model Form which states:

> "[ABC Oil Company] shall be the operator of the Contract Area and shall direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement. In its performance of services hereunder for

the non-operators, operator shall be an independent contractor not subject to the control or direction of the non-operators except as to the type of operation to be undertaken in accordance with the election procedures contained in this agreement. Operator shall not be deemed or hold itself out as the agent of the non-operators with the authority to bind them to any obligation or liability assumed or incurred by operator as to any third party. Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation, but in no event shall it have any liability as operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct" (emphasis supplied).

Article VII of the 1989 Form negates a partnership, joint venture, agency or fiduciary relationship and states specifically:

"In their relations with each other under this Agreement, the parties shall not be considered fiduciaries or to have established a confidential relationship but rather shall be free to act on an arm's length basis in accordance with their own respective self interests, subject however, to the obligations of the parties to act in good faith in their dealings with each other with respect to its activities hereunder" (emphasis supplied).

It is significant to note that the forms prior to 1989 did not negate agency, did not specifically negate a fiduciary relationship, did not call the operator an independent contractor and did not obligate the parties to act in good faith. Most reported litigation has occurred under the prior forms. Thus, a case on one of these issues under the 1989 Form could yield a different result. It should be noted however, that the courts have characteristically looked not only to the agreement, but to the conduct of the parties and therefore, in some instances where conduct has transgressed the express terminology, all precedents may be inapplicable. *See Berchelmann v. Western Co.*, 363 S.W.2d 875 (Tex. Civ. App.--El Paso 1963, writ ref'd n.r.e.) and *Russell v. French & Assocs. Inc.*, 709 S.W.2d 312 (Tex. App.--Texarkana 1986, writ ref'd n.r.e.).

In Arkansas, there is precedent for a non-operator to claim that he and the operator under Joint Operating Agreement are in a fiduciary relationship. In the case of *Texas Oil & Gas Corporation v. Hawkins Oil & Gas*, 668 S.W.2d 16 (Ark. 1984), the Supreme Court of Arkansas considered the case of a Non-Operator who brought an action claiming the Operator owed him a fiduciary duty. The lower court found the Operator was holding a portion of the leases in trust for the Non-Operator and the Operator appealed. The Court found a fiduciary relationship, finding that all the elements of a partnership were present and therefore a joint venture had been undertaken. The Court found that where the Operator executed a second series of leases contrary to the position of his non-operated partner, it violated his relationship of trust and confidence between the Operator and Non-Operator which had come about by the execution of the original Joint Operating Agreement (JOA). *Id.* at 271.

2. General Discussion

Any discussion of this area must take note of several excellent articles quoted and which should be studied. R. BLEDSOE, *The Operating Agreement: Matters Not Covered or Inadequately Covered*, 47 ROCKY MT. MIN. L. INST. § 15.01 (2001); E. SMITH, *Duties and Obligations Owed by an Operator to Non-Operators, Investors and Other Interest Owners*, 32 ROCKY MT. MIN. L. INST. §§ 12.01, 12.03[5] (Matthew Bender 1986); GLASS, *Operating Agreement Issues*, 10th ANNUAL ADVANCED OIL, GAS & MINERAL LAW COURSE 1992; HENDRIX AND GOLDING, *The Standard of Care in the Operation of Oil and Gas Properties*, 44 INST. ON OIL & GAS L. & TAX'N § 10-1, 1993. As shown by these articles, the courts of Texas for the most part have negated a partnership relationship, a fiduciary relationship and, in most cases, an agency relationship as between the operator and the non-operators, although there have been some other jurisdictions that have found a fiduciary relationship. Several cases have shed additional light on the duties of the operator. First, in *Johnston v. American Cometra Inc.*, 837 S.W.2d 711 (Tex. App.--Austin, 1992, writ denied), the 1977 Model Form was at issue. The non-operator argued that the operator was obligated to make a take-or-pay claim under a Gas Contract and the court discussed the duty of the operator. The court determined that the duty to perform "in a good and workmanlike manner" as expressed in a 1977 Form meant that the operator was obligated to perform "as a reasonable prudent operator". This marked the first time that a Texas Court has clearly enunciated this standard. The court further stated:

> "In addition to its duty to act as a reasonably prudent operator, if Cometra acted as agent of the non-operators in entering into the gas purchase contract with respect to the sale of gas, Cometra owes to the non-operators all those duties owed by an agent to its principal." *Id.* at p. 710.

Thus, not only did the court clarify the duty but it also announced an additional agency duty which, in effect, means that at least a fiduciary obligation existed with respect to the handling of the gas contract. The court quoted *Smith* in stating "the act of selling for another implies a principal-agent relationship. An operator who markets gas on behalf of non-operators may have a duty to protect the rights of such non-operators in the event of disputes with gas purchasers."

The liability of the operator as a qualified agent was fortified by the holding in *Atlantic Richfield Co. v. Long Trusts*, 860 S.W.2d 439 (Tex. App.--Texarkana 1993, writ denied). Pursuant to Article VI(C), in what appears to be a 1977 Form, Atlantic Richfield ("ARCO"), who was a successor of the original operator, sold the non-operator's gas to one of its wholly owned subsidiaries under a long term interest. The subsidiary made a profit on the transaction when it sold the gas at a higher price than the price it had paid ARCO. The facts indicated that the subsidiary received $2.90 per MMBTU for the Plaintiff's gas that had been sold by ARCO to the subsidiary for a price of $1.60 and $1.40 per MMBTU. The non-operators who had not elected to market their own gas sued ARCO claiming that it had not obtained "the best price obtainable in the area for such production" pursuant to the Agreement. The court determined that "best price obtainable" for the plaintiff's gas should be compared to similarly uncommitted production in the area and not to gas committed to the long term contract because if the plaintiff had wished to obtain a higher price, it

had the option of negotiating separately with any gas purchaser. The Operating Agreement did not require ARCO to sell gas on behalf of the plaintiff. The court was unwilling to rewrite the agreement to provide that ARCO's option had abruptly become its duty. The plaintiff was held not to be a third party beneficiary of the contract and the court held there was no duty on ARCO to renegotiate or to not renegotiate contracts in which the plaintiff has no vested interest. However, the court turned to the agency argument articulated in the *Johnston* case, *supra*, and found that ARCO was the agent of the plaintiff and had sold gas through its alter ego. The court determined that the plaintiff was entitled to damages for any profits from the sale of gas by its agent. ARCO argued that it was not receiving any compensation for selling the plaintiff's gas, but the court held that a gratuitous agent is subject to the same duty to account as is a paid agent. The agency relationship is thus clearly created under pre-1989 Forms when an operator sells gas on behalf of a non-operator. The court did recognize the right of the subsidiary to make a reasonable charge for transportation.

In addition to the agency holding, it is interesting to note that the court apparently ignored the exculpatory provisions of the Operating Agreement in both the *Long Trusts* and the *Johnston* cases. It is submitted that this is consistent with the forms for the reasons hereafter stated because these were both claims based on contract activities under the Operating Agreement and not "operations" on the "Contract Area."

One other aspect of this case is also noteworthy. ARCO argued that because the plaintiff had breached the Operating Agreement by failing to pay joint interest billings, it could not then seek to enforce the agreement. The court held that the first breach was by ARCO and the plaintiff was not barred from suit by its later breach.

Perhaps the operator under the 1956, 1977 or 1982 forms, while conducting operations on the Contract Area, should be absolved of the normal negligence standard because the nature of oilfield operations is potentially dangerous. As to matters which require judgment and which do not pertain to actual field operations on the Contract Area, e.g., filing for variances with the Texas Railroad Commission, it is submitted that the reasonable operator standard should apply without application of the exculpatory clause. This is borne out by a close look at the language of the Model Form Operating Agreement.

An important principle of contract construction is that the law looks to all provisions of the contract and seeks to reconcile them. Thus the standard required of the operator performing activities on the contract area is different--he is not to be liable except in cases of gross negligence or willful misconduct. Article V(A) of all Pre-1989 Forms should apply only to actual operations on the Contract Area. The second sentence of Article V(A) refers to "<u>such operations</u>" just before the exculpatory language appears. With respect to other activities expressly addressed in the agreement (*i.e.*, accounting, billing, record keeping, etc.), which are covered in many other provisions, neither the good and workmanlike conduct nor the exculpatory provision should apply. Instead, the ordinary contract/breach analysis should apply. Otherwise the exculpatory provision severely modifies many other contractual provisions. This analysis is consistent with *Johnston* and *Long Trusts*.

More recent case law has clarified the application of the standards by which the operator's conduct is to be measured. The "good and workmanlike," "gross negligence," and "willful misconduct" concepts found in the exculpatory clause do not apply when the issue is breaches of the operating agreement as opposed to improper operations on the contract area. In *Cone v. Fagadau Energy Corp.,* the Eastland Court of Appeals directly addressed whether the exculpatory clause applies to breach of contract claims. 68 S.W.3d 147, 154-55 (Tex. App.-Eastland 2002, pet. denied). In *Cone*, a non-operator sued the operator for breach of the operating agreement because the operator directly charged the non-operator for expenses not allowed under the agreement's COPAS provision. The operator specially excepted asserting that no cause of action had been asserted because the non-operator did not allege that the operator had failed to charge in a good and workmanlike manner or was grossly negligent or committed willful misconduct. The Eastland Court reversed holding:

> Cones's complaints did not allege the failure of . . . [the operator] to operate in a good and workmanlike manner. Rather, Cone's complaints alleged breaches of the specific terms of the agreement and are in the nature of an accounting . . . The gross negligence/willful misconduct requirement applies to any and all claims that the operator failed to conduct operations in a good and workmanlike manner.

Id. at 155 (citing *Abraxas Petro. Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. App.-El Paso 2000, no pet). In *Abraxas*, the El Paso Court of Appeals concluded, "the exculpatory clause is limited to claims based upon an allegation that . . . [the operator] failed to act as a reasonably prudent operator and does not apply to a claim that it breached the JOA." 20 S.W.3d at 759; see also *Castle Prod. L.P. v. Long Trusts*, 2003 WL 21771718, * 13 (Tex. App.-Tyler July 31, 2003, pet. denied)(unpublished); *IP Petroleum Co., Inc. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888, 894-96 (Tex. App.-Houston [1st] 2003, pet. denied)(exculpatory clause applies to claims resulting from operations).

Contrary to those recent Texas cases, the federal case of *Stine v. Marathon Oil Co.*, 976 F.2d 254 (5th Cir. 1992), construed the 1982 Form. Stine, the non-operator, claimed that Marathon, the operator, breached its contract by not turning over operation of two wells to Stine before plugging and abandoning them, by not furnishing information as required under the Operating Agreement, and by failing to complete wells in certain oil sands. Additionally, Stine claimed that Marathon tortiously interfered with Stine's gas contract by collecting proceeds thereunder to pay Stine's defaults in payments of billings. Thus the court had squarely before it a mix of claims relating to operations and also to administrative and accounting duties. The Plaintiff successfully argued in the trial court that the exculpatory language applied only to the physical acts of the operator on the contract area while Marathon argued that the clause protected the operator from any acts done under the operating agreement, whether in tort or in breach of contract. The court said:

> ". . . in the present case, Marathon is not liable for any action taken in connection with the completion, testing or turnover of any well drilled under the provisions of the JOA unless Stine can prove that Marathon's actions were grossly negligent or willful. <u>This protection extends to Marathon's various administrative and accounting duties including the recovery of the costs under the authority of the JOA</u>. It is clear

to us that the protection in the exculpatory clause extends not only to 'acts unique to the operator' as a district court expressed it, but also to any acts done under the authority of the JOA 'as operator'. This protection clearly extends to breaches of the JOA. It also reaches other acts including acts performed 'as operator' under the authority of the JOA that amount to tortious interference with contracts with third parties. We, therefore, hold that the exculpatory clause protects Marathon from liability for any act taken in its capacity "as operator" under the JOA (except for gross negligence or willful misconduct)." (emphasis added).

976 F.2d at 260.

In reaching this decision, the *Stine* court quoted as precedent two 5th Circuit cases from Louisiana and two Texas cases. Of the two Texas cases, one did not even pertain to an Operating Agreement and the other was *Hamilton v. Texas Oil and Gas Corp.*, 648 S.W.2d 316 (Tex. App.--El Paso 1982, writ ref'd n.r.e.), which pertained to actual operations on the contract area.

The *Stine* decision, which is a federal decision, is thus inconsistent with *Cone, Abraxas,* and *IP Petroleum Co.*, all Texas Courts of Appeals decisions.

There is also a 10th Circuit Court of Appeals' opinion which restricts the exculpatory language to tort claims and not breach of contract. In *Shell Rocky Mountain Production, LLC v. Ultra Resources, Inc.*,415 F.3d 1158 (10th Cir. 2005), the 10th Circuit Court considered a breachof contract wherein Ultra alleged that the Operator (Shell), had overcharged working interest owners for drilling costs that were significantly above prevailing rates in the area, breaching the competitive rate provision of the JOA. In its defense, Shell argued that the exculpatory clause in Section A of the JOA released them from liability unless their actions rose to the level of gross negligence or willful misconduct. *Id.* at 1169. The Court ruled that the contract breaches at issue were not covered by the exculpatory clause and that the exculpatory clause only applied to tortious actions, saying that the unit operator was to conduct all operations in "a good and workmanlike manner." *Id.*

B. Different Operating Agreements--Same Contract Area.

Consider the situation where the operator has secured execution of separate Operating Agreements with different parties on the same land, each Operating Agreement showing the interest of only one non-operator and crediting the remaining interest actually owned by others to the operator. The 1956, 1977 and 1982 Model Forms provide that the Agreement is binding upon the parties and their respective heirs, devisees, legal representatives, successors and assigns and may be signed in counterparts. The 1989 Model Form in Article XV(B) and (C) contains a similar provision and adds that the terms of the Agreement should be deemed to run with the leases or interests included within the Contract Area. Article XV(A) in the 1989 Model Form provides that a signing non-operator is bound notwithstanding that other proposed non-operators have not signed the same agreement.

Thus, it is clear that none of the Model Form Operating Agreements are designed for this fact situation, but it is often the case that there are different Operating Agreements between different parties covering the same contract area, and in some cases the Operating Agreements have been changed in various substantive provisions.

Two cases deal with this indirectly. *Osborne v. Rogers,* 363 P.2d 219 (Okla. 1961) featured two separate agreements with the same operator, but with different non-operators and different provisions. The court quoted paragraph 8 of both Operating Agreements which state:

> "The rights and obligations of the parties hereunder shall be individual and several and not joint nor collective. Each party shall be responsible for his obligations only, and it is understood and agreed that this Agreement does not create a partnership or group association between the parties hereto".

The operator sued a non-operator for costs and the non-operator denied liability on the grounds that the provisions of the Operating Agreement relating to overhead that he had signed had been deleted by another non-operator and that these deletions constituted a modification of the defendant's contract as well. The court held the defendant to the contract he had signed without regard to the modification insisted upon by another non-operator.

Also, in *Hondo Oil & Gas Co. v. Texas Crude Operator Inc.,* the court had little difficulty enforcing different accounting procedures for different non-operators. The court said:

> ARCO further asserts that an operator cannot charge different overhead rates to non-operators who sign the same Operating Agreement. ARCO therefore believes it must be charged the same rate as Amoco. ARCO's argument is based upon contractual provisions stating parties will be charged their proportionate share of the costs and expenses.
>
> Although the non-operators signed the same Operating Agreements, they have no special relationships between them establishing any fiduciary duty. Testimony at trial established that it was not uncommon to charge different rates to different non-operators on the same well and that variations and rates are the product of negotiations. ARCO might have a legitimate claim of breach of contract if Texas Crude charged at a rate higher than its proportionate share, but no evidence was presented to support such a claim. Evidence only established that Amoco was charged a rate at less than its proportionate share. Essentially, Texas Crude decided it would take the loss from Amoco rather than fight with Amoco. Texas Crude's decision to take a loss on Amoco does not require it to take a similar loss on ARCO's overhead payments. Amoco and ARCO are different parties and Texas Crude may consider different factors in determining whether to take a loss on either party."

970 F.2d 1433 (5th Cir. 1992). In essence, therefore, it appears that each contract will apply to that party only.

Given the decision in *Hondo, supra*, in order to counteract the above, some parties might contend one agreement between all parties exists because, after a period of time, all were made aware of the provisions of all the agreements which happened to be the same.

Separate Operating Agreements with each non-operator create acute problems when a non-operator makes a well proposal to which the operator must respond. The operator's interest, as reflected in that Operating Agreement, includes interests actually vested in numerous other parties. If the operator elects to join in the well, does he become responsible for the entire interests as shown in his agreement with the proposing party? If he wishes to decline, does he necessarily go non-consent for all parties when one of the other non-operators might wish to join in the well? What non-consent clause applies? What if there are different percentages in the different Operating Agreements? It is impossible to make any predictions other than that the operator will regret having prepared his JOA in this manner.

II. Joint Interest Audits under the Accounting Procedure

Introduction

The COPAS Accounting Procedure was developed to set the guidelines for the charging of costs by the operator to the non-operators. During the process of accounting for mutual costs and the billing for such costs, problems are generally resolved by audits by the non-operator of the operator's books and records.

Audits are frequently conducted according to a set of "rules" which are based either on the actual terms of the particular Accounting Procedure at issue, or are based on COPAS publications (formerly bulletins, interpretations, research papers, etc. which have been developed as an aid to the oil and gas industry). COPAS did not intend that their guidelines supersede or override existing contracts and these various COPAS publications were not published as standards. Rather, they are recommended procedures and practices which may explain, interpret or elaborate on specific oil and gas accounting issues. See COPAS ACCOUNTS, Vol. 17, No. 3, September 1996, p. 4. COPAS has now republished many of its former publications as AG's (Advisory Guidelines) and MFI's (Model Form Interpretations).

Audit conflicts frequently occur because the billing procedures followed by the operator are "generic" rather than specific. The larger operators frequently adopt a program or protocol for making charges to the joint account without regard to the particular form of a model or "manuscript" agreement in effect on a particular property. Or, the operator will charge according to a COPAS interpretation or bulletin which contains a suggestion for charging certain kinds of costs without the operator obtaining permission of the non-operators for making charges according to that bulletin or interpretation. Frequently, both the operator and the non-operator have a perception about how the agreements are "supposed to work" instead of a clear understanding of their actual contractual rights and obligations as written. This is what I call the "lore" rather than the "law."

This discussion will (1) review the scant body of law interpreting the COPAS Accounting

Procedure, (2) discuss problems involving joint account issues and audit issues that have been encountered in litigation involving the construction of parties' actual rights and obligations under the COPAS Accounting Procedure as written, and (3) discuss issues arising out of the 2005 COPAS Accounting Procedure recommended by the Council of Petroleum Accountants Societies.

A. COPAS Accounting Procedure--Limitations.

The 1984 COPAS Accounting Procedure in section I, paragraph 4 provides:

> Payment of any such bills shall not prejudice the first of any non-operator to protest or question the correctness thereof; provided, however, all bills and statements rendered to non-operators by operator during any calendar year shall conclusively be presumed to be true and correct after twenty-four (24) months following the end of any such calendar year, unless within the said twenty-four (24) month period a non-operator takes written exception thereto and makes claim on operator for adjustment. No adjustment favorable to operator shall be made unless it is made within the same prescribed period. . . .

In *Anderson v. Vinson Exploration Inc.*, 832 S.W.2d 657 (Tex. App.--El Paso 1992, writ denied), the operator sued non-operator for non-payment of certain bills and the non-operator was not allowed to question the reasonableness or justice of the charges because no written exceptions were taken within the twenty-four month period.

A similar result was reached in *Calpetco 1981 v. Marshall Exploration, Inc.*, 989 F.2d 1408 (5th Cir. 1993). The court said:

> "The accounting procedures bound Calpetco to the validity of all of Marshall's charges unless it had taken written exception thereto and made claim on Marshall for adjustment within the twenty-four month period".

However, where there has been fraud or fraudulent concealment of material facts the internal statute of limitations will be inapplicable. In *Exxon Corporation v. Crosby-Mississippi Resources, Ltd.*, 775 F. Supp. 969 (I.D. Miss. 1991), the court analyzed the "conclusive presumption" language of the accounting procedure and concluded the presumption was rebuttable if there was a showing of fraud or bad faith breach of contract. The court was uncomfortable with the notion that the operator could flagrantly overcharge the non-operator and then enforce the payment if there had been no audit.

In a claim by the operator against the non-operator, the courts have applied the four year statute of limitations because it is a suit on a contract. *See Hondo Oil & Gas Co. v. Texas Crude Operator Inc.*, 970 F.2d 1433 (5th Cir. 1992). In *XCO Production Company v. Jamison*, ___ S.W.3d ___ (Tex. App. - Houston (14th Dist.) 2005 unpublished), the working interest partner in oil and gas properties sued the other partner alleging breach-of-contract. Upon a finding for claimant, XCO appealed contending that the contract claim was barred by a statute of limitations

clause within the accounting procedures section which stated as follows: "All bills and statements rendered to Non-Operators by Operator during any calendar year shall conclusively be presumed to be true and correct after 24 months following the end of any such calendar year, unless within the said 24 month period a Non-Operator takes written exception thereto and makes claim on Operator for adjustment." *Id.* at 11. Defendant argued this provision established a two-year statute of limitations for the Non-Operator to contest any costs deducted by the Operator during a given year. The Court of Appeals overruled this argument, holding that since both Jameson and XCO were both non-operating interest holders, the 24-month limitation did not apply. *Id.*

In *Stephenson v. Oneok Resources Company*, 99 P.3d 717 (Okla. Civ. App. 2004 *cert. denied*), the Court of Civil Appeals of Oklahoma considered an appeal wherein Non-Operators sought a declaratory judgment against an Operator, namely that the Operator was not entitled to raise overhead charges retroactively under a Joint Operating Agreement. The JOA in question had an attached COPAS Accounting Procedure that allowed an Operator to change the overhead rate as provided: "Below rates shall be adjusted as of the first day of April each year following the effective date of the Agreement to which this Accounting Procedure is attached." *Id.* at 719. The JOA allowed a higher overhead rate during drilling and provided for a lower one when the well was producing. The Accounting Procedure portion of the JOA contained a stipulation that all bills and statements by Operator would be presumed to be correct after 24 months if the Non-Operators had not taken written exception. After three years as Operator, Oneok conducted an internal audit and discovered that the necessary overhead had not been escalated in prior years. Operator then retroactively adjusted the overhead rate back two years. Non-Operators refused to pay this recalculated rate, partially triggering the action.

On appeal, the Operator argued that the language of the JOA stated that well rates "shall" be adjusted each year stemming from the initial overhead rate. The Non-Operators argued that while the language allowed for an annual adjustment on the first day of April, it did not require it. Further, they argued the adjustment could only be made to the rate currently in use, not necessarily the initial overhead rate. Finally, they asserted the JOA barred any adjustment more than two years after the billing was presented and paid by Non-Operators. Cross-motions for summary judgment on interpretation of the COPAS consistent with each party's position were filed but the court denied both summary judgments and submitted the issues to a jury. The jury returned a verdict in favor of the non-operator's position and against the operator. The trial court judgment provided that the operator could only charge overhead rates on the rates in use when the operator acquired its interest in 1997 and any escalations thereafter. The Court of Appeals found that the Accounting Procedures were reasonably susceptible to different interpretations and that the trial court did not err in submitting this as a jury question. *Id.* at 722.

B. Fixed Rate v. Actual Costs.

The 1984 COPAS Accounting Procedure contained elaborate descriptions of direct charges in Section II which could be charged to the joint account. Section III of the procedure dealt with producing and drilling overhead charges which could be on a fixed rate basis or a percentage basis.

The 1995 COPAS Accounting Procedure provides a new option which is a "mega fixed rate" per active well which is intended to cover all costs applicable to joint operations except for royalties, production/severance taxes, ad valorem taxes, controllable materials, downhole well work and drilling wells and projects. In lieu of that mega fixed rate the parties can elect more traditional direct charges as set out in Sections III, IV and V of the procedure which cover costs incurred on the joint property, costs incurred off the joint property, and overhead, respectively. The "mega fixed rate" is one to be negotiated by the parties and then charged on a monthly basis based on the number of active completions on the joint property. Those exceptions to the fixed rate generally are the types of charges which are not as routine and predictable. The non-routine operations which are excluded from the megafixed rate are chargeable as costs, and depending on the location of the activity, will either be covered by direct charges, allocations, or overhead. The 1995 COPAS is location-determinative, i.e., if the cost is incurred on the joint property, it is a direct charge to the joint account; if the charge is incurred off the property, it may be allocated or covered by the overhead rates depending in part on the agreement negotiated by the parties. Section III of the 1995 COPAS Accounting Procedure covers costs incurred on the joint property which is defined as the "real and personal property subject to the agreement to which this accounting procedure is attached." Section IV covers costs incurred off the joint property which are incurred for "joint operations." "Joint operations" is defined as "activities required to handle specific operating conditions and problems for the exploration, development, production, protection, maintenance, abandonment, and restoration of the joint property." Thus, under Section III, direct charges can be made for employees, material and personnel engaged in activities which have occurred on the joint property. In Section IV, costs incurred at locations that fit the definition of joint operations even if they do not occur on the property can fall into the category of facilities, ecological/environmental, legal expense, training, or engineering, design and drafting which can nevertheless be charged to the joint account. Thus, for example, engineering time performed for the joint operations but not on the joint property can nevertheless be charged to the joint account under these provisions. Other types of charges, i.e., not direct or allocated, can then be subsumed under overhead which is a more traditional approach under prior COPAS accounting procedures.

Query: If the operator is paid one mega fixed rate (not including the exceptions), what auditable conduct will there be? If the operator collects such an amount, what provision of the Accounting Procedure requires expenditures of sums that would otherwise be described and accounted for in the specific Accounting Procedure Sections III through V? Moreover, how could parties ever reasonably come to a figure which would approximate the direct cost of all the things described in those sections? If the mega fixed rate is used, the only auditable conduct would probably be whether the operator was "reasonably prudent." Whether an operator has been reasonably prudent is a difficult standard to audit since it is a fact issue that may depend on the person or persons making the assessment. *See Johnston v. American Cometra Inc.*, 837 S.W.2d 711 (Tex. App.—Austin, 1992, writ denied); *Norman v. Apache Corp.*, 19 F.3d 1017 (5th Cir. 1994); c.f. *Westbrook v. Watts*, 268 S.W. 2d 694, 697-98 (Tex. Civ. App.—Waco 1954, writ ref'd n.r.e.) (interpreting good and workmanlike manner, "in the context of a drilling contract, to mean `as a reasonably prudent person engaged in drilling oil wells'"); ERNEST E. SMITH, *Duties and Obligations Owed by an Operator to Non-Operators, Investors, and Other Interest Owners*, 32 ROCKY MTN. MIN. L. INST. 12-1, 12-30 (1986) ("the reasonable prudent operator standard, which governs the lessee's conduct under the

typical oil and gas lease, is normally assumed to govern the operator's conduct under the operating agreement also").

One of the areas which is of concern in COPAS circles recently is the fact that the Crude Petroleum and Gas Production Workers Index is no longer available. In the 1984 COPAS form, fixed rates are escalated based on the percentage increase or decrease in the average weekly earnings of Crude Petroleum and Gas Production Workers for the last calendar years compared to the calendar year preceding as shown by the index of average weekly earnings of Crude Petroleum and Gas Production Workers as published by the United State Department of Labor, Bureau of Labor Statistics, or the equivalent. The 1995 COPAS stated that amended rates will be calculated "in accordance with COPAS recommendations." Since the old index is no longer published by the Department of Labor, COPAS has concluded that by "blending the Oil and Gas Extraction Index with the Professional and Technical Services Index, the results approximate the data from the old Crude Petroleum and Natural Gas Workers Index." COPAS Economic Factors, Accounting Procedure Wage Index Adjustment. The change was approved by COPAS at its April 23, 2004 Council Meeting. COPAS also points out that Model Form Interpretation 50 suggests that each company make its own determination as to whether or not it needs to amend its contracts to use it or any other new Index.

Query: If you are using an 1984 Accounting Procedure, will the parties to the JOA agree that the new "blended" index will be the "equivalent " of the former index specifically referenced in that form of agreement?

In the 2005 COPAS, the parties agree that the adjustments to overhead rules will be computed by applying the adjustment factor most recently published by COPAS. The adjusted rules shall be the initial or amended rules agreed to by the parties increased or decreased by the adjustment factor described in the COPAS for each year from the effective date of such rules, in accordance with COPAS MFI-47 ("Adjustment of Overhead Rules").

C. Role of the Audit.

1. 1984 COPAS Accounting Procedure

The COPAS Accounting Procedure gives the non-operator the right to audit the operator's books and records. Specifically, Section I, paragraph 5.A. provides:

> A non-operator, upon notice in writing to operator and all other non-operators, shall have the right to audit operator's accounts and records relating to the Joint Account for any calendar year within the twenty-four (24) month period following the end of such calendar year; provided, however, the making of an audit shall not extend the time for the taking of written exception to and the adjustments of accounts as provided for in Paragraph 4 of this Section I. Where there are two or more non-operators, the non-operators shall make every reasonable effort to conduct a joint audit in a manner which will result in a minimum of inconvenience to the operator.

> Operator shall bear no portion of the non-operators' audit cost incurred under this paragraph unless agreed to by the operator. The audits shall not be conducted more than once each year without prior approval of operator, except upon the resignation or removal of the operator, and shall be made at the expense of those non-operators approving such audit.

The COPAS Accounting Procedure also provides for exceptions or adjustment to the joint interest billing. Section I, paragraph 4 of the COPAS Accounting Procedure provides as follows:

> Payment of any such bills shall not prejudice the right of any non-operator to protest or question the correctness thereof; provided, however, all bills and statements rendered to non-operators by operator during any calendar year shall conclusively be presumed to be true and correct after twenty-four (24) months following the end of any such calendar year, unless within the said twenty-four (24) month period a non-operator takes written exception thereto and makes claim on operator for adjustment. No adjustment favorable to operator shall be made unless it is made within the same prescribed period. The provisions of this paragraph shall not prevent adjustments resulting from a physical inventory of Controllable Material as provided for in Section V.

2. 1995 COPAS Accounting Procedure

(a) Accounts and Records

The 1995 procedure provides that the non-operator "shall have the right to audit the operator's accounts and records relating to the Joint Account for any calendar year within the 24-month period following the end of such calendar year; however, conducting an audit shall not extend the time for the taking of written exception to any adjustments of accounts as provided for in Paragraph 4 of this Section I." Paragraph 5.A. That paragraph goes on to provide in pertinent part: "A timely filed audit report or any timely submitted response thereto shall suspend the running of any applicable statute of limitations regarding claims made in the audit report. While any audit claim is being resolved, the applicable statute of limitations will be suspended; however, the failure to comply with the deadlines provided herein shall cause the statute to commence running again."

(b) Timing of an Audit and the Operator's Response

Under paragraph 5.A., the audit report is to be issued within 180 days after completion of the audit field work.

In paragraph 5.B., the operator is required to allow or deny exceptions in writing within 180 days after receipt of such report. The denied exceptions are to be accompanied by substantive response and, if the operator fails to provide substantive information on denials within the time frame provided, the operator will pay interest on the exception, if ultimately granted, from the date of the audit report.

The 1995 provisions do not make clear what "applicable statute of limitations" is to be suspended. Is it the so-called "internal statute of limitations" set out in the 24-month adjustment period, or the applicable statute of limitations for breach of contract or fraud in that state? Or is it the two-year statute of limitations applicable to torts because the Joint Operating Agreement to which the Accounting Procedure attaches provides that the operator shall not be liable except in the case of gross negligence or willful misconduct?

In addition to those time periods for audit report and operator response, the 1995 COPAS Accounting Procedure in paragraph 5.C. provides that the lead audit company shall reply to the operator's response to an audit report within 90 days of receipt and the operator shall reply to the lead audit company's follow up response within 90 days of receipt. If the lead audit company does not provide a "substantive response" to the operator within 90 days, that unresolved audit exception will be disallowed. If the operator does not provide a "substantive response" to the lead auditor's follow up response within 90 days, that unresolved audit exception will be allowed and credit given to the joint account. The COPAS authors leave us wondering who will decide that audit exceptions are "detailed" enough and responses are "substantive" enough to conform to the Accounting Procedure.

Although the 1995 COPAS Accounting Procedure has now built in a process that takes one year and a half, the procedure now further provides that the lead audit company or operator may call an audit resolution conference for the purpose of resolving audit issues/exceptions that are "outstanding at least 18 months after the date of the audit report." Such resolution meeting requires that the "attendees will make good faith efforts to resolve outstanding issues, and each party will be required to present substantive information supporting its position. An audit resolution conference may be held as often as agreed to by the parties. Issues unresolved at one conference can be discussed as subsequent conferences until each such issue is resolved." Paragraph 5.A.

As a practical matter, it is very questionable whether a meeting between non-operators and an operator over issues which have been pending more than 18 months will result in resolution of the historically disputed issues. A mandatory arbitration provision was considered in the drafting of the 1995 Accounting Procedure, but not adopted. While parties are certainly free to modify the Accounting Procedure to add such provisions, as a practical matter it is sometimes difficult to include non-standard provisions in a published Accounting Procedure. Arbitration of disputes is quickly becoming the norm in stock broker-client contracts and in other areas of frequent disputes such as the employer-employee relationship. Given the complexity of joint interest accounting and the likelihood that these kinds of disputes will proliferate rather than subside with the 1995 Accounting Procedure, the inclusion of a provision for arbitration seems a practical, economic and fair way to resolve issues which are very costly to address in the context of full-blown litigation. Moreover, the fallacy of the entire audit process is that if the operator and non-operator disagree on the interpretation of the obligation of the operator under the Accounting Procedure, the operator ultimately is the sole authority of what it will grant as an exception and what it will refuse. When larger operators have adopted policies and procedures that affect hundreds if not thousands of jointly-operated properties, they are often reluctant, if not downright recalcitrant, to grant an exception, no matter how the language of the Joint Accounting Procedure differs from their "global" joint venture accounting practices or procedures.

SUPREME COURT OF ARKANSAS
ARKANSAS CONTINUING LEGAL EDUCATION BOARD
Justice Building
625 Marshall
Little Rock, AR 72201
501-374-1855

REQUEST FOR CLE CREDIT BY A PROGRAM SPEAKER

TO BE COMPLETED BY SPEAKER

(NOTE: MODERATORS WHO DO NOT CONTRIBUTE SUBSTANTIVE INSTRUCTION MAY NOT RECEIVE ENHANCED CREDIT AS A SPEAKER).

1. Title of CLE program:________________________________

2. Subject of your presentation:__________________________

3. Date(s) and location(s) upon which you taught:

   (1)____

   (2)____

4. _If_ your presentation was as a solo speaker (not part of a panel), how long was your presentation? (calculated on basis of 60-minute hour or portion thereof, rounded to nearest 1/4 hour)__________________. Did you prepare or distribute written materials for your presentation?
   ___ yes ___ no

5. _If_ your presentation was as a member of a _panel_, how long was the panel presentation in its entirety? (calculated on the basis of a 60-minute hour or portion thereof, rounded to nearest 1/4 hour)______________ Did you prepare or distribute written materials for your panel presentation?
   ____ Yes ____ No

6. The undersigned speaker represents that the presentation(s) noted above comply with the Arkansas Rules for Minimum Continuing Legal Education and any regulations promulgated pursuant thereto. The speaker further understands and acknowledges that the Arkansas Continuing Legal Education Board reserves the right to determine the number of CLE hours to which the undersigned attorney is entitled as a CLE speaker for this program.

7. Print name:____________________ Signature:________________

8. Tel. No.___________Ark. Supreme Court Reg. No.______________

9. Mailing Address:____
P.O. Box or Street

____
City State Zip Code

CERTIFICATE OF ATTENDANCE FOR
REMAINDER OF ABOVE PROGRAM

In addition to the credit I am claiming above for speaking at this program, I certify that I am entitled to claim _____ general credit hours and _____ ethics hour(s) as a result of attendance during the remainder of the program. Do not include in the above total(s) the amount of time claimed for your presentation.

____
Signature

TO BE COMPLETED BY SPONSOR

1. Sponsor ID#: A003 Program ID#:____________

2. The undersigned sponsor representative confirms the representations made by the above mentioned CLE speaker, (only to the extent of the presentation,) and, further confirms that the presentation was in compliance with the Arkansas Rules for Minimum Continuing Legal Education and any regulations promulgated pursuant thereto.

3. Sponsor name: Arkansas Bar Association

Sponsor representative: Virginia Hardgrave

____
Date

3. 2005 Accounting Procedure

The 2005 COPAS provides that expenditure audit exceptions for the preceding 24 month period must be made by the end of the calendar year following such 24 months; otherwise the billings are conclusively presumed to be true and correct for that period.

Audit deadlines	Activity
90 days	Issuance of Audit Report A. (Conducted in accordance with AG-19["Expenditure Audits in the Petroleum Industry; Protocol and Procedure Guidelines"] B. The issuance of a timely audit will toll the statute of limitations.
180 days	Written response by Operator (Operator owes interest if response isn't timely.)
90 days	Reply by lead audit company
90 days	Reply by Operator
15 months	If any audit issues are still outstanding, either party may call a resolution meeting. If you don't attend, any party to the JOA loses the right to object to the resolution reached at the meeting.
60 days	If the resolution meeting is unsuccessful, a mediation can be requested and held 60 days from the date of the mediation request.

4. Cases Discussing the Timing and Content of Audit Expenditure Exception

Anderson v. Vinson Exploration, Inc., 832 S.W.2d 657, 665-66 (Tex. App.—El Paso 1992, writ denied), upheld the trial court's refusal to submit an issue on the reasonableness of charges billed to non-operators because the only evidence at trial was that the charges were reasonable. The court held that the plaintiffs were not entitled to an issue absent evidence of unreasonableness. *Id.* The court states that the plaintiffs "were required under the accounting procedure addendum to the joint operating agreement to take written exception to any bills and statements with which they disagreed within twenty-four months after statements were rendered. There is no evidence that this was ever done . . . ." *Id.* Similarly, in *Exxon Corp. v. Stack*, LEXIS 10941 *8 (S.D. Ala. 1992), a non-operator who failed to pay joint interest billings was prevented from challenging the statements because he did not except in writing to the charges within the 24-month period. However, as will be discussed, despite this language, an exception exists which would make the evidence admissible — if not to rebut the charges, then for another limited purpose.

While the Fifth Circuit has also held that non-operators are bound by the operator's statements unless written exception is taken thereto, this opinion sets forth circumstances under which written exception need not be taken. *Calpetco 1981 v. Marshall Exploration, Inc.*, 989 F.2d 1408 (5th Cir. 1993). In *Calpetco v. Marshall*, Marshall was the operator of numerous oil and gas properties in which various Calpetco partnerships invested. *Id.* at 1410. The Calpetco partnerships began investing with Marshall in 1979. *Id.* In 1982, the general partner of Calpetco expressed concerns about the investment to the president of Marshall and in 1985, Calpetco began to question representations made by Marshall. *Id.* Calpetco began to review charges made from 1981-84 and request documents from Marshall. *Id.* Calpetco claimed Marshall overcharged the Calpetco partnerships; Marshall claimed that some of the Calpetco partnerships had not paid amounts due to Marshall. *Id.* Marshall reviewed some of Calpetco's accounts and some adjustments were made. *Id.* However, the parties did not resolve their dispute and in April 1987, Marshall filed suit against five of the Calpetco partnerships for non-payment of the charges. *Id.*

Marshall sought a declaration that charges questioned by Calpetco were conclusively presumed correct; Calpetco counterclaimed urging breach of contract, fraud and misrepresentation. *Id.* at 1410-11. Marshall moved for partial summary judgment that Calpetco's claims were barred by either the contractual 24-month adjustment period or the four year limitations period for breach of contract. *Id.* at 1411. Calpetco contended that the limitations period was tolled because Marshall fraudulently concealed its overcharges thus preventing Calpetco from discovering its claims in a timely manner. *Id.* Calpetco filed an affidavit of an auditor of oil and gas operations who was an active member of COPAS, who testified that the 24 month limitation period was never intended as "an outright bar against protests and objections after the expiration of the 24 month period." *Id.* at n.5. The trial court granted Marshall's summary judgment, concluding that the Accounting Procedures were "clear and unambiguous" and that they governed "the procedures for charges and credits for the entire project." *Id.* at 1411. Another of Marshall's partial summary judgment points was granted that Calpetco did not timely object to any of the challenged charges which were "conclusively presumed true and correct." *Id.* The court excluded all evidence of overcharges at trial and judgment was entered in favor of Marshall. *Id.* at 1411-12.

The Fifth Circuit agreed with the trial court that the Accounting Procedures, including the 24-month adjustment period, governed billings and payments between the parties for all ventures. *Id.* at 1413. However, the court noted that the application of the adjustment period would be foreclosed in cases of fraudulent concealment, waiver, or estoppel. *Id.* However, the court ultimately held the limitations period was not tolled because Calpetco did not offer sufficient summary judgment proof of fraudulent concealment. *Id.* at 1414. Due to an apparent misunderstanding of a non-movant's burden at the summary judgment stage, Calpetco did not offer any summary judgment evidence of fraudulent concealment, relying instead on a conclusory affidavit which stated that Marshall "employed delaying tactics" and "actively misled Calpetco . . . [and] effectively precluded Calpetco from discovering in a timely manner the invalidity of the charges and overcharges." *Id.* at 1413 & n.15. Approximately two weeks later Calpetco filed a motion to reconsider to which it attached extensive proof the court found "very persuasive," but not timely filed, overruling Calpetco's motion. *Id.*

Furthermore, it is a well established principle that records which might otherwise be considered "conclusive," may be attacked as fraudulent. *Id.* at 1413-14; *Sanitary Farm Dairies v. Gammel*, 195 F.2d 106, 113-14 (8th Cir. 1952).

In *Exxon Corp. v. Crosby-Mississippi Resources, Ltd.*, 775 F. Supp. 969, 975 (S.D. Miss. 1991), *aff'd in part and rev'd in part*, 40 F.3d 1474 (5th Cir. 1995), the District Court held that the COPAS provision entitled the operator's monthly billing statements to a conclusive presumption of correctness if written exception to the statements was not made within the specified time period. In addition, the Court held that the provision did not violate the Mississippi statute which prohibited contractual limitations periods which altered the statutory limitations period for a cause of action by holding the provision was a condition precedent which did not violate the statute. *Id.* at 976. Furthermore, while noting that a "conclusive presumption" was "[an] artificially compelling force which requires the trier-of-fact to find such fact as is conclusively presumed and which renders evidence to the contrary as inadmissible," the court held a conclusive presumption is nonetheless refutable upon a showing of fraud or bad faith breach of contract. *Id. citing Caddo Oil Co., Inc. v. O'Brien*, No. 86-0988 (W.D. La. 1988), *aff'd*, 908 F.2d 13 (5th Cir. 1990) (in which there was no allegation or proof of fraud; therefore, the documents on their face were conclusive). The Court of Appeals affirmed the trial court's decision that the documents were conclusively presumed correct; that the provision created an evidentiary presumption "albeit a conclusive one" in favor of the joint interest billings; and that the presumption was not irrebuttable and could be rebutted upon a finding of fraud or bad faith breach of contract. *Exxon Corp. v. Crosby*, 40 F.3d 1474, 1486 (5th Cir. 1995)(construing Mississippi law).

Finally, the New Mexico Bankruptcy Court has held that the COPAS provision is a binding contractual provision in which the parties to the contract agreed that 24 months was a reasonable time to object to the statements and that a party's failure to object within the time specified waives his right to object thereafter. *In re Antweil*, 115 Bankr. 299, 304 (Bankr. D. New Mex. 1990).

Obviously, what constitutes taking "specific detailed written exception" as required in paragraph 4.A. of the 1995 Accounting Procedure is unclear because that phrase is not a defined term in either the Accounting Procedure or the typical joint operating agreements. In *Calpetco v. Marshall*, Calpetco contended that the filing of its counterclaims constituted written exception to the charges. However, the court stated, "Marshall correctly pointed out that those counterclaims could not, as a matter of law, constitute a written claim for adjustment: they do not point to specific charges or specific invoices." 989 F.2d at 1416. In *Exxon v. Crosby-Mississippi*, Crosby argued that its answer, interrogatories and requests for production constituted written exception to the charges. 775 F. Supp. at 978. The court held material issues of fact existed preventing the granting of a summary judgment as to whether such pleadings constituted written exception to the charges, noting that "written exception" was not defined in the parties' contract. *Id.* After a bench trial, the court concluded the discovery requests did not constitute written exceptions. 40 F.3d at 1476 & n.1. Crosby did not appeal this holding. *Id.*; *See also Exxon Corp. v. Stack*, in which the court held a party's interrogatories (which did not specify why the charges were unreasonable or to what extent they were excessive) did not constitute "written exception" to an operator's charges, based upon expert testimony that an exception must be clear and specific. *Exxon Corp. v. Stack*, LEXIS 10941

at *7-8.

The case of *Castle Prod. L.P. v. Long Trusts*, 2003 WL 21771718 (Tex. App.-Tyler July 31, 2003, pet. denied)(unpublished) provides a cautionary tale as to how payments must be proved up in court. Castle was a successor in interest to Atlantic Richfield's interest in several producing leases. The Long Trusts was a non-operator which was banking its share of gas. When Castle began sending out joint interest billings to the Long Trusts, they never paid any of these invoices. Castle was selling the Long Trusts' share of condensate but accounting to them only sporadically. It was Castle's claim that it was netting out condensate sales against what the Long Trusts owed on their joint interest billings. The Long Trusts argued that JIB's were not revenue account instruments and therefore could not be used for that purpose. The Court of Appeals reviewed the JIB's and concluded that there were no entries for credit for production. Moreover, the Court agreed with Long Trusts that in order to prove payment when payments are in dispute, the one seeking to prove payment must do so under Rule 95 of the Texas Rules of Civil Procedure which provides in pertinent part:

> When a defendant shall desire to prove payment, he shall file with his plea an account stating distinctly the nature of such payment, and the several items thereof; failing to do so, he shall not be allowed to prove the same, unless it be so plainly and particularly described in the plea as to give the plaintiff full notice of the character thereof.

Tex. R. Civ. P. 95.

The trial court excluded Castle's evidence of payment because they failed to comply with Rule 95 and the Court of Appeals upheld that exclusion.

A couple of Arkansas cases, such as *Collins Securities Corporation v. Federal Deposit Insurance Corporation*, 998 F.2d 551 (8th Cir. 1993), have supported the general principle that records which might otherwise be considered "conclusive," particularly under the 24-month stipulation in the COPAS Accounting Procedure, can be re-examined if circumstances indicate the records are fraudulent.

In *SEECO, Inc. v. Hales* , 22 S.W.3d 157 (Ark. 2000), the Arkansas Supreme Court considered a case where royalty owners sought allegedly unpaid royalties from a gas producer and their related utility corporation. At trial, the royalty owners offered proof that the monthly royalty statements sent to them by SEECO were fraudulent. The Supreme Court reaffirmed that the party claiming fraudulent concealment must show as an element justifiable reliance on the false representation. In *SEECO*, this proved a low bar to hurdle, as the allegedly fraudulent royalty check stubs, which were held to be misleading, were considered enough for the Supreme Court to determine that the element of justifiable reliance had been met.

D. Material Purchases, Transfers and Dispositions.

The provisions of Section VI in the 1995 COPAS Accounting Procedure (involving the pricing of equipment transferred out of the operator's 100% inventory) purport to allow use of either (a) the appropriate COPAS historical price multiplier ("HPM"), or (b) prices provided by the COPAS Computerized Equipment Pricing System ("CEPS") as an alternative to price quotations that will reflect the current realistic acquisition costs, historical purchase prices, or (c) "as agreed to by the parties." See VI.2.A.(1-4).

The 1995 Accounting Procedure attempts to remedy abuse by operators charging for materials by defining material purchased under a "vendor stocking program" as a direct purchase. This section was drafted to eliminate abuses by an operator moving all materials through a stocking point and then pricing the material as a transfer to the joint account at a different (almost always higher) price. The spirit of the 1995 procedure is that if material is purchased for a joint account project, it should be charged at cost and not artificially routed through an operator's yard to justify the charging of a higher price. However, what the 1995 procedure "giveth" it has also "taken away," in that the non-operator may be lulled into accepting CEPS, or Computerized Equipment Pricing System, price for transferred material which is based on antiquated price quotations which bear very little relation to current prices. To the extent CEPS has been modified by COPAS HPM, or the Historical Price Multiplier, it is intended that such prices more nearly reflect current market value. However, the non-operator should be diligent in researching the issue since this has been an area involving considerable malfeasance.

Note also that used material is not automatically fixed at 75% for Condition B or 50% for Condition C, but is now written to allow charges for used pipe based on the most recent COPAS recommended percentages instead of providing fixed adjustments as in the past.

The 2005 COPA generally tracks the 1995 material pricing methodology but also allows pricing based on a price quotation from a vendor that reflects current realistic acquisition cost or is based on the amount paid by the Operator within the previous twelve (12) months from the date of physical transfer.

E. Affiliates.

1. 1984 COPAS Accounting Procedure

The 1984 COPAS Accounting Procedure defines "First Level Supervisors," "Technical Employees" and "Personal Expenses." It does not specifically define "Affiliate."

2. 1995 COPAS Accounting Procedure

The 1995 COPAS Accounting Procedure does not define "First Line Supervisors," "Technical Employees" or "Personal Expenses." However, it does define an affiliate as follows: "'Affiliate' shall mean, with respect to the operator, any party directly or indirectly controlling, controlled by, or under common control with the operator." The 1995 Procedure goes on to provide

in paragraph 6 that charges to the joint account for any services or materials provided by an Affiliate shall not exceed "average commercial rates for such services or Materials."

There is no requirement in the 1995 COPAS which would require the Affiliate to be otherwise engaged in the business of offering goods and services of the type provided to the joint account, that the Affiliate have other customers or third party relationships, or that the Affiliate truly have the experience and expertise to offer the goods or services which are being billed to the joint account.

In the 1984 COPAS, direct charges for material are provided for in Section II, paragraph 5, and for services in Section II, paragraph 7. There is no discussion as to whether such goods or services may be purchased from an Affiliate.

The 1995 Accounting Procedure provides not only that services or Materials may be provided by an Affiliate at average commercial rates, but permits the party to check a blank in which the parties agree that records relating to the work performed by Affiliates will not be available for audit.

The 2005 COPAS requires the Operator to identify the goods and services provided by an affiliate or allows the parties to elect that the total costs of such affiliate's goods and services billed to an individual project do not exceed a dollar amount to be agreed upon by the parties.

More and more frequently there are audit disputes over an operator's utilization of affiliated companies, either sister or subsidiary companies, which are part of the "family" of companies of the operator. There is nothing inherently wrong with the use of Affiliates, but there are some problems which arise in joint venture accounting which could be avoided by more specific drafting of the document.

Use of related entities for services and materials presents three distinct problems.

First, were the services or materials actually necessary? The operator could increase profits of the related entity by ordering and using unnecessary materials and services. This is extremely difficult to detect and verify through the usual audit as it requires considerable engineering and operational knowledge and expertise. However, the operator is under common law duties and duties under the JOA to operate in a reasonable and prudent fashion, and ordering excessive or unnecessary services would violate this duty. Having stated that, query how the duty to be a reasonably prudent operator is balanced against the typical language in the JOA which limits an operator's liability to those instances in which the operator commits gross negligence or willful misconduct.

Second, the services and materials provided by the related entity may not be of the same standard or quality provided by an independent vendor. This is also difficult to detect or verify during an office audit. A materials audit can verify that the materials on hand in the yard or installed on the lease are of the quality invoiced, unless the related entity had deceptively characterized the materials themselves. We have seen problems involving related entities mislabeling tubular goods

as being of a higher quality or as having been tested in certain particulars, when such was not the fact.

Third, under the 1995 COPAS Accounting Procedure, the Affiliate may charge commercial rates for its goods or services. The non-operators typically rely upon an operator's self interest (being the owner of a working interest in the project) as a means of insuring that the operator will acquire services and materials at the lowest possible cost. However, if the operator (or the operator's principal) owns the related entity, the profits realized by the related entity may more than offset the increased expenses to the operator's working interest share of the joint account.

COPAS seems to be backtracking to some extent from its Interpretation No. 16 which generally provided that before a related entity's charges could be taken into account as if third party invoices, related entity must have a substantial customer base. Interpretation No. 16 generally also provided that the related entity could charge the particular joint account no more than it charged its other customers. If under the 1995 procedure it is interpreted that the Affiliate need not have a separate customer base or true "arms length" contracts with others, then the potential for abuse is high, particularly if the parties have checked the blank disallowing audits of Affiliates.

If audits of the Affiliate are not allowed, then the non-operator may find itself in the position of one non-operator of which we are aware in an unreported case who discovered the operator named in the JOA actually had no employees, and no equipment, not even a stapler. Instead, it used related entities to perform every service and provide all materials for the operation of the property. The result was the operator's records consisted solely of highly summarized invoices from the related entity. Auditing the operator's records in such an instance was of no benefit since all the backup and support for the charges was in the files of the related entities. In such an instance, the only way to properly audit the operations would be to audit the books and records of the related entity. If related entities provide services or materials for the joint account, we believe the better procedure is for the non-operator and operator to agree to the language set out in Section I, paragraph 6 of the 1995 Accounting Procedure which provides: "Unless otherwise indicated below, Affiliates performing services or providing materials for joint operations shall provide the operator with written agreement to make the records relating to the work performed for the joint account available for audit upon request by a non-operator under this Accounting Procedure."

F. Operator Standard of Care for Failure to Follow the Accounting Procedure.

The 1989 JOA provides in Article V that the operator's duty to the non-operator is as follows:

> Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation, but in no event shall it have any liability as operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.

Under the JOA [and presumably, its addendum, the COPAS Accounting Procedure], the courts have imposed a duty on the operator to act reasonably and prudently. *See Johnston v. American Cometra, Inc.*, 837 S.W.2d 711 (Tex. App.—Austin 1992, writ denied). At least one court has found that an operator breaching the terms of the JOA is liable under contract principles. *Atlantic Richfield Co. v. Long Trusts*, 860 S.W.2d 439. However, the Fifth Circuit in *Stine v. Marathon Oil Co.*, 976 F.2d 254, 267 (5th Cir. 1992), held that any breaches of the various administrative and accounting duties under the COPAS Accounting Procedure will create liability for the operator only if the operator's actions were grossly negligent or constituted willful misconduct. *Id.* at 260. The "exculpatory clause" at issue in *Stine* is typical of those found in model form JOA's, including that quoted above. Specifically, the *Stine* JOA provided that the operator "shall conduct all operations in a good and workmanlike manner, but it shall have no liability as operator to the other parties except such as may result from gross negligence or willful misconduct." *Id.* at 260. Thus, the jury verdicts against the operator in *Stine*, which were based on simple breach of contract and negligence, could not stand.

In particular, the "good and workmanlike," "gross negligence," and "willful misconduct" concepts found in the exculpatory clause do not apply when the issue is breaches of the operating agreement as opposed to improper operations on the contract area. In *Cone v. Fagadau Energy Corp.*, the Eastland Court of Appeals directly addressed whether the exculpatory clause applies to breach of contract claims. 68 S.W.3d 147, 154-55 (Tex. App.-Eastland 2002, pet. denied). In *Cone*, a non-operator sued the operator for breach of the operating agreement because the operator directly charged the non-operator for expenses not allowed under the agreement's COPAS provision. The operator specially excepted asserting that no cause of action had been asserted because the non-operator did not allege that the operator had failed to charge in a good and workmanlike manner or was grossly negligent or committed willful misconduct. The Eastland Court reversed holding:

> Cones's complaints did not allege the failure of . . . [the operator] to operate in a good and workmanlike manner. Rather, Cone's complaints alleged breaches of the specific terms of the agreement and are in the nature of an accounting . . . The gross negligence/willful misconduct requirement applies to any and all claims that the operator failed to conduct operations in a good and workmanlike manner.

Id. at 155 (citing *Abraxas Petro. Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. App.-El Paso 2000, no pet). In *Abraxas*, the El Paso Court of Appeals concluded, "the exculpatory clause is limited to claims based upon an allegation that . . . [the operator] failed to act as a reasonably prudent operator and does not apply to a claim that it breached the JOA." 20 S.W.3d at 759; see also *Castle Prod. L.P. v. Long Trusts*, 2003 WL 21771718, * 13 (Tex. App.-Tyler July 31, 2003, pet. denied)(unpublished); *IP Petroleum Co., Inc. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888, 894-96 (Tex. App.-Houston [1st] 2003, pet. denied)(exculpatory clause applies to claims resulting from operations).

To the extent the exculpatory clause applies, attention should be given to the definition of gross negligence. "Gross negligence" is a term in the exculpatory clause of the JOA and the name of an action in tort law. In *Hamilton v. Texas Oil & Gas Corp.*, gross negligence was considered in

the context of a joint operating agreement. 648 S.W.2d 316 (Tex. App.-El Paso 1982, writ ref'd n.r.e.). Reviewing the liability of an operator for the damages incurred by non-operators after a drilling site was relocated, the court of appeals used the same definition of gross negligence that was voiced in *Burke Royalty. Hamilton*, 648 S.W.2d at 323. Finding that there was evidence that could meet this definition, the *Hamilton* court found that the exculpatory clause was satisfied and affirmed damages for the plaintiff. *Id.* The court did not provide any explanation, but despite the tort nature of this standard and its use in assessing punitive damages, the court readily adopted the common law definition of gross negligence at that time to apply to the term in the joint operating agreement.

The next case found involving a joint operating agreement which discussed the definition or elements of gross negligence was *I.P. Petroleum Co. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888 (Tex. Civ. App.-Houston [1st Dist. 2003] 2003, pet. denied). Here again, non-operators seeking damages from the operator for gross negligence needed to satisfy an exculpatory clause. The case was decided upon a jury instruction that used a definition of gross negligence adopted from § 41.001(5) of the Texas Civil Practice & Remedies Code. *See Id.* at 897. The court noted, though, that it was unclear if this was the proper definition given the timing of the case, but this was only a timing issue and not a matter of the source of the definition. *See Id.* Again, the tort standard for gross negligence was used.

Both *Hamilton* and *I.P. Petroleum* used the tort definitions for gross negligence to determine liability under the exculpatory clause of the JOA. However, the definitions used in these cases - and even which definition should have been used in *I.P. Petroleum* - depend on timing. These two cases support the use of the tort standard in the JOA context; however, it must be determined what definition from which point in time should be used.

In 1990, the Supreme Court considered a phase severance contract that lacked a definition for the important term 'casing head gas.' *Amarillo Oil Co. v. Energy-Agri Products, Inc.*, 794 S.W.2d 20 (Tex. 1990). The court decided that because there was a statutory definition at the time of the making of the contract, that definition was to be incorporated. *See Id.* at 22. The court held that by failing to insert a definition, the parties "evidenced their intent to incorporate the statutory definition". *Id.* This conclusion was based upon *Smith v. Elliott & Deats*, which stated that "laws which subsist at the time and place of the making of a contract ... enter into and form a part of it, as if they were expressly referred to or incorporated in its terms." 39 Tex. 201, 212 (1873).

This premise, that the terms of a contract carry the meaning recognized by the law at the time of the making of the contract, carries back further than the 1873 case. The idea draws from the principal evoked by Article I, Section 16 of the State Constitution: "no bill of attainder, ex post facto law, retroactive law, or any law impairing the obligation of contracts, shall be made." TEX. CONST. art. I, §16. It is duly noted, that this clause "is not intended to deny the right of the legislature to vary the motive enforcing a remedy". *DeCordova v. City of Galveston*, 4 Tex. 470 (1849) (interpreting an earlier constitution, but the same language). Since even this early date, the difference between remedies and obligations has been recognized. In the case of the exculpatory clause, though, the meaning of gross negligence will determine when imposing liability against the operator occurs.

Based upon these principals, *Amarillo Oil* instructs that the meaning of gross negligence in the exculpatory clause of any particular JOA is the definition of gross negligence as understood by the law at the time of its making of the agreement. *See* 794 S.W.2d at 22. This utilization of the tort standard is further supported by analogous uses in cases in 1992 and in 2003. *See I.P. Petroleum*, 116 S.W.3d at 897 and *Hamilton*, 648 S.W.2d at 323.

G. Applicability of AG's and MFI's.

The 2005 COPAS has several references to MFI's which should be reviewed in connection with evaluating the terms of the COPAS accounting procedures.

1. Re: Unambiguous Agreement

Query: What impact do COPAS Bulletins or Interpretations or Advisory Guidelines or Model Form Interpretations have on any given Accounting Procedure if the terms of the Accounting Procedure are unambiguous?

The law is well-settled that "[e]vidence of custom is . . . not admissible to contradict the plain unambiguous covenants and agreements expressed in the contract itself." *Dal-Mac Constr. Co. v. Victor Lissiak, Jr., Inc.*, 524 S.W.2d 554, 557 (Tex. Civ. App. - Waco 1975, no writ). For example, in *The Frost Nat'l Bank v. L & F Distributors, Ltd.*, 122 S.W.3d 922, 931 (Tex. App. - Corpus Christi 2003, pet. filed), the court refused to consider parol evidence of custom and usage to vary the terms of an unambiguous contract. The court relied, in part, on a merger clause, but noted as follows:

> Even if the parties had not included a merger clause, we would decline to consider any parol or extrinsic evidence because the contract language disputed in this case is unambiguous. . . . Although course of performance, course of dealing and usage in trade can supplement or qualify the express terms of a contract, they cannot be invoked to alter and contradict the terms of an unambiguous contract, see *Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 732 (Tex. 1981). (Internal citation omitted).

The *Frost National Bank* court earlier observed that "[a]n ambiguity does not arise simply because the parties offer conflicting interpretations," and that "[i]f a written contract is worded so that it can be given a definite or certain legal meaning, then it is unambiguous." Id. at 930.

These principles are thoroughly established under Texas law. As another court explained:

> Where the instrument is clearly unambiguous, and the intention and meaning of the parties can be ascertained from the writing itself, parol evidence cannot be received of a custom or usage which will change the plain meaning of the words or phrase used in the instrument, or give it a meaning different from their natural import, or to discover its meaning. The office of the usage is to interpret the otherwise indeterminate meaning of the words used so as to fix and explain their doubtful

meaning. Custom is never admissible, or read into a written instrument, to contradict what is there plainly stated. . . .

Iowa Canning Co. v. F.S. Ainsa Co., Inc., 267 S.W. 540, 541-42 (Tex. Civ. App. - El Paso 1924, no writ) (reversing and rendering a take-nothing judgment for the defendant because the court allowed the jury to consider evidence of custom and usage). See also *Corso v. Carr*, 634 S.W.2d 804, 808 (Tex. Civ. App. - Fort Worth 1982, writ ref'd n.r.e.) ("[T]he introduction of custom and usage in this case by parol evidence was highly improper and erroneous. Evidence of custom and usage is not competent to contradict the plain and unambiguous terms of an express contract nor to vary, control, impair, restrict, or enlarge the explicit language of the agreement.").

2. Re: Timing of Interpretations *vis a vis* Agreement

Query: Would Interpretations which predate the 1995 or 2005 COPAS Accounting Procedure be considered as custom and industry practice when not specifically referred to in the 1995 or 2005 Accounting Procedure?

Query: Would Interpretations issued by COPAS after the 1995 or 2005 COPAS Accounting Procedure fall within the exclusion noted in another context in *Humble Exploration Co. v. Amcap Petroleum Associates-1977*, 658 S.W.2d 860, 862 (Tex. App.—Dallas 1983, writ ref'd n.r.e.) (dispute concerned whether the Windfall Profit Tax was encompassed by the provision for deduction of taxes from net production proceeds — court held since the Windfall Profit Tax was not enacted until after the agreement at issue had been executed, it would have no effect on the agreements). Practitioners should consider whether an Interpretation or Bulletin or AG or MFI issued subsequent to the execution of a JOA or COPAS Accounting Procedure can have any impact on the agreements. *Id.* at 862.

H. Conclusion

There are more questions about the rights and obligations of parties under the JOA and COPAS Accounting Procedure than there are reliable answers. Such answers as the courts have historically given us are not particularly satisfactory to those of us who litigate the industry's "model forms." More attention ought to be given by the industry to mediation/arbitration of accounting disputes in order to avoid overreaching by operators and/or costly and protracted litigation.