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Realizing the potentiality for the mishandling of oil and gas production mortgages and other secured lending devices involved in acquiring expansion and acquisition funds, Mr. Jensen analyzes the liability of the engineer making the oil and gas reserve estimates upon which such loans are based and indicates the significant problems and anticipated court resolution.

## LENDER RECOUPMENT FOR OIL NOT IN PLACE

*Donald L. Jensen\**

THE recent evanescence of mortgaged salad oil and fertilizer tanks should prompt lenders to re-examine an even more volatile security, oil and gas reserves.

A primary source of acquisition and expansion funds utilized by the oil industry is oil and gas reserves. Acquisitions are generally molded upon the *ABC*<sup>1</sup> pattern for tax purposes<sup>2</sup> while working capital is derived through production mortgages covering numerous properties scattered throughout the area of interest of the borrower. The security supporting both the production mortgage and the *ABC* oil payment is the oil and gas reserves assigned to the mortgagor's or seller's productive property by evaluating petroleum engineers.

Production mortgages follow a more or less typical pattern. In the usual instance the mortgagor owns producing properties and varying interests in numerous fields in several states. The mortgagor expends proportionately large amounts of capital in the exploration and development of its properties and its primary assets are oil and gas reserves in the

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1. Typically *A* owns the producing oil and gas reserves which are conveyed to *B*. In the conveyance *A* reserves an oil payment which is conveyed to *C*; *C* in turn pledges the oil payment to a lender.
2. For a discussion of tax advantages of the *ABC* transaction see 2 WILLIAMS & MEYERS, OIL AND GAS LAW § 423.11 (2d ed. 1964).

ground and associated producing equipment. To obtain capital, the mortgagor pledges its reserves from time to time to various banks and lending institutions. In support of its loan application, the mortgagor furnishes the lender a reserve evaluation report prepared by a reputable engineering firm of the mortgagor's selection, or in the case of smaller loans, the borrower furnishes reservoir information to the bank's engineers. Assuming agreement as to the loan value of the security, *i.e.*, the discounted present worth of the reserves in the ground, the mortgagor then furnishes the lender title opinions covering the producing properties together with various security instruments.

The financial and oil industries have viewed the security instruments necessary to protect the oil industry lender as being conventional in nature; however, the typical deed of trust or mortgage contains numerous industry type covenants. A divergence of opinion exists concerning assignments of production. Many lenders demand a present assignment of either all or a portion of the hydrocarbons produced from the mortgaged leaseholds and a like assignment of all proceeds received which are attributable to the sale of such hydrocarbons—other lenders rely upon a covenant to assign upon a future request by the lender. As an adjunct to the former procedure, transfer or division orders are executed by the borrower and lender with the lender usually disclaiming any warranty of title.<sup>3</sup> This type of documentation places a duty of accounting upon the lender. A duty which, in the case of numerous producing interests, can become quite onerous. Also, this method of documentation may expose the lender to the extra hazards of a good faith conversion.<sup>4</sup>

The present tendency of lenders is to not demand a present assignment of production but to rely upon a covenant by the borrower to assign the production from the mortgaged

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3. The effectiveness of this type of disclaimer is subject to question. In *Pan Am. Petro. Corp. v. Long*, 340 F.2d 211 (5th Cir.), *cert. denied*, 381 U.S. 926 (1964), a lender was held liable on a conversion theory to a leaseholder for oil illegally produced from a cross-country well bore. The transient well bore bottomed on Pan American's lease but produced from equipment located upon adjacent property leased by a Mr. Long. Mr. Long mortgaged the property to Southwestern Life Insurance Company (SWL) who executed division orders with a disclaimer "without warranty of any kind either expressed or implied." The court found this language to be of little significance.

4. *Pan Am. Petro. Corp. v. Long*, *supra* note 3.

property to the lender upon receipt by the borrower of a written request from the lender to do so. In the absence of a present assignment, the borrower continues to receive all proceeds from the numerous pipeline purchasers and remits periodic payments to the lender. Division or transfer orders are not executed by the lender until default and such procedure should isolate the lender from the conversion theory noted above.

The lending documents may require a periodic oil and gas reserve review by a petroleum engineering firm to reaffirm the amount and value of the lender's security interest. Also, the borrower may request such a review by the evaluating firm from time to time if the reserves possess a long productive life since the present net worth of reserves to be produced in the future increases each succeeding year and the borrower may be able to increase its borrowing base.

Reserve evaluation plays a similarly vital role in the *ABC* transaction. Company *A*, the selling company, will either provide reservoir data to all interested buyers or, as in the case of the larger sales, will obtain a reserve report by a reputable petroleum engineering firm. The ultimate sale price of Company *A* will reflect to a large extent the value placed upon its oil and gas reserves. Company *C*, the oil payment purchaser, may use the same reserve report in obtaining financing for the production payment.

In both transactions, the lender is dependent upon the value and the presence of the oil and gas reserves as represented by the evaluating engineering firm. In production mortgage situations, the borrower may not possess additional assets which could be reached for the indebtedness should the production fail. In the *ABC* pattern, *C* may be a tax exempt charitable corporation with no appreciable additional assets, or *C* may be a tax effacing corporation formed for use as an oil payment vehicle.

The evaluation procedures of reservoir engineering firms encompass a perimeter from cursory to as detailed as the information concerning the characteristics of the properties permits. Historically, reserve estimates have been grossly understated and the lenders grossly over-secured. In the past

few years, however, engineers have tended to become less cautious and more realism has crept into their evaluations.

The accumulation of data which will ultimately determine the lending value of a particular property commences with the initial discovery well. If the well-site geologist is extremely perceptive or is vested with extreme good luck, or both, a large amount of the information necessary for a proper evaluation will be derived through the drilling, testing, and completion of the discovery well. In many instances however, management of the company, upon being advised of a probable producing wildcat, may prefer to discontinue drilling very near the top of the potential producing formation to obviate the possibility of destroying the well.

Therefore, with one completed well the information available to the evaluating petroleum engineer may be minimal. The engineer may, however, hazard an estimate based upon such available minimal information as to probable reservoir characteristics. From this estimate and with a possible twinge of conscience, the engineer will assign initial reserves to the well. These assigned reserves become, in the semantics of the profession, "proven" reserves. The adjacent spacing units are endowed with nomenclature of being "probable" reserves and the spacing units once removed become "possible" reserves. As each successive well is drilled, more information will become known and the engineer will be better advised in the assignment of reserves. However, there are few developing fields in which a sufficient amount of accurate information is available to foster a proper evaluation.

The reservoir engineering firm is faced with multiple and unusual variables in its evaluations. It must consider elements such as porosity, permeability, gravity, pressure, volume, drive mechanism, formation characteristics and numerous other factors in arriving at its estimate of the amount of hydrocarbons owned by the borrower.<sup>5</sup> These variables are compounded by the various productive areas in which the borrower owns producing interests.

After the evaluator has established a theoretical amount

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5. For a discussion of evaluation procedures, see Polumbus, *Techniques of Evaluating Oil Properties*, 2 ROCKY MT. MIN. L. INST. 387 (1956).

of reserves, the next task is to assign a present value to such oil and gas in place. Again variables are present, such as the future price of crude, projected lifting costs, and possible rates of production, as effected by the vicissitudes of the nations economy.

As an adjunct to consideration of the formational and economic variables, it would seem prudent to add the external influences that may effect the firm's evaluation. Engineering firms in production mortgage and oil payment situations are very often retained and paid by the selling or mortgagor companies and may be subject to a variety of influences. It would also seem entirely possible that an evaluator would be inclined to accept the veracity of information supplied to it by the proposed mortgagor or seller in many areas rather than obtaining the same information at a disproportionate cost from outside sources. In addition, there are numerous small producing fields in which the information necessary for a proper evaluation may be solely within the possession of the mortgagor or seller, who may elect to withhold detrimental information.

It is a tribute to the petroleum engineering profession that lender losses have been so limited in the past; but perhaps, in view of the miasmatic history of fertilizer tanks and salad oil, it would be timely to consider a lender's opportunity for recoupment for incorrect evaluation of oil and gas reserves. This is particularly so if we consider how much easier it is to measure salad oil in tanks or to count fertilizer equipment in use than it is to measure oil and gas in the ground.

The question of a petroleum engineer's liability for misstated oil and gas reserves appears to be most easily considered by the utilization of a hypothetical situation. Therefore, assume that A corporation requested a reserve evaluation from Cursory Engineers. A advised Cursory that the purpose of the evaluation was an intended sale of A's producing properties. Upon completion of the reserve study, Cursory furnished A 50 counterparts of its evaluation. The study contained a certificate to the effect that Cursory evaluated A's producing properties based upon information supplied by A and that Cursory utilized sound and accepted engineering practices in its evaluation.

A corporation delivered the reserve reports to potential buyers. After protracted negotiations, Company *B* agreed to purchase the oil and gas properties. *C* Company agreed to act as the oil payment purchaser and *T* Bank consented to lend the necessary funds against a pledge of an oil payment by *C*. *T* Bank's consent and *B*'s purchase were based upon their analysis of the reserve report. Seventy-five per cent of the proceeds of the sale of oil and gas were dedicated to the oil payment and *B* was to receive the remaining twenty-five per cent.

The evaluated properties fail to produce either the annual anticipated revenues or the total recoverable reserves stated by *Cursory*. *T* Bank being vindictive by nature elects to attempt recovery from *Cursory*. Unfortunately, the domicile of *T* Bank's theory for recovery is the legal profession's semantic wonderland of the law of fraud and negligence. The semantics involved are that a negligent misrepresentation bears no liability without privity of contract while the contrary applies to a fraudulent representation; this generalization being modified by an addendum that a grossly negligent misrepresentation also yields liability. Although the separately stated theories of fraud and negligence be tending to coalesce,<sup>6</sup> and the nuances and shadings of the differentiation being dissolved; for purposes of this discussion each theory of *T* Bank's vendetta will be considered separately.

If *T* Bank elects a concept based upon the negligence of *Cursory*, such negligence would be measured by the standard of care required by professional practitioners, *i.e.*, "The law imposes upon persons performing architectural, engineering, and other professional and skilled services the obligation to exercise a reasonable degree of care and skill as, under similar conditions and like surrounding circumstances, is ordinarily employed by their respective professions."<sup>7</sup> The rule which is applied to architects and which is easily equated to other reasonably prudent professionals, such as petroleum engineers, is:

a person who holds himself out to the public in a

6. See *Texas Tunneling Co. v. City of Chattanooga*, 204 F. Supp. 821 (D. Tenn. 1962).

7. *Bodin v. Gill*, 216 Ga. 467, 117 S.E.2d 325, 330 (1960). *Housing Authority of City of Carrollton v. Ayers*, 211 Ga. 728, 88 S.E.2d 368, 373 (1955).

professional capacity holds himself to be possessed of average ability in such profession, and the law implies that he contracts with his employer (1) that he possesses that requisite degree of learning, skill and experience which is ordinarily possessed by the profession in the same art or service, and which is ordinarily regarded by the community, and by those conversant with that employment, as necessary and sufficient to qualify him to engage in such business; (2) that he will use reasonable and ordinary care and diligence in the exercise of his skill, in the application of his knowledge, to accomplish the purpose for which he is employed; (3) in stipulating to exert his skill and apply his diligence and care, an architect like other professional men, contracts to use his best judgment.<sup>8</sup>

Depending upon the circumstances, the professional may be required to possess the "intelligence befitting his profession";<sup>9</sup> however, infallibility is not demanded<sup>10</sup> and the practitioner, be he architect, engineer, lawyer or accountant, is entitled to a wide discretion in the selection of methods or practices in the performance of his work.<sup>11</sup>

As with any other legally established peer group, the ambit of professional duty also encompasses its furthest

8. 6 C.J.S. *Architects* § 19 n.44 (1937).

9. *Lane v. Inhabitants of Town of Harmony*, 112 Me. 25, 90 A. 546, 548 (1914).

10. *Gagne v. Bertran*, 43 Cal. 2d 481, 275 P.2d 15, 21 (1954):

The services of experts are sought because of their special skill. They have a duty to exercise the ordinary skill and competence of members of their profession, and the failure to discharge that duty will subject them to liability for negligence. Those who hire such persons are not justified in expecting infallibility, but can expect only reasonable care and competence. They purchase service, not insurance.

11. *Gammel v. Ernst & Ernst*, 245 Minn. 249, 72 N.W.2d 364, 54 A.L.R.2d 316 (1955).

Ordinarily, the standards of reasonable care which apply to the conduct of auditors or public accountants are the same as though applied to lawyers, doctors, architects, engineers, and other professional men engaged in furnishing skilled services for compensation. The imposition of such standards does not leave them without adequate protection since their liability and damages arises only as the result of methods or practices in the performance of their work which indicate lack of reasonable care, fraud, or bad faith and since they are entitled to a wide discretion in the selection of such methods and in determining which of several practices or principles is most sound or best suited for the work undertaken by them.

*Id.*, 72 N.W.2d at 367.



reaches from "standing high in his profession,"<sup>12</sup> to "unreasonable negligence and lack of skill."<sup>13</sup>

With the establishment of the median of professional performance, the next direction of inquiry would be to those encompassed within the protection of the duty.

In the hypothetical situation, the agreement concerning the reserve report was between Cursory engineers and A, the selling company. Neither B, the purchaser, nor C, the purchaser of the oil payment, nor T Bank was a party to the agreement. However, Cursory had actual notice of the intended use or, if not, constructive notice could easily be imputed.

Whether T Bank, C, and B are included within the compass of the duty depends upon privity of contract. Justice Cardozo considered this question in discussing an accountant's negligence in *Ultramares Corporation v. Touche*.<sup>14</sup> In that case the lender, Ultramares Corporation, attempted recovery from the accountants, Touche, Niven & Co., for money loaned on the basis of a certified balance sheet derived from the falsified books of a bankrupt corporation. Cardozo refused to extend the duty of the accountants to the lender based upon negligence.

In *Ultramares*, as in our hypothetical, the defendants knew or had cause to know that the result of their labors would be used in a wide variety of instances, such as exhibiting the certificate to banks, creditors, purchasers, etc. Admitting the negligence of the audit, Cardozo states:

A different question develops when we ask whether they owed a duty to these [the creditors and investors to whom the balance sheet was shown] to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of decep-

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12. *Lane v. Inhabitants of Town of Harmony*, *supra* note 9.

13. 3 AM. JUR. *Architects* § 19 (1936):

An architect will also be held responsible for damage sustained by his employer where, due to unreasonable negligence and lack of skill, his plans and specifications were faulty and defective. But his undertaking does not imply or warrant a satisfactory result. There is no assurance that miscalculations will not occur. Liability rests only on unskillfulness or negligence, and not upon mere errors of judgment.

14. 255 N.Y. 170, 174 N.E. 441, 74 A.L.R. 1139 (1931).

tive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.<sup>15</sup>

Cardozo found the limits of the accountants' liability to be bounded by privity of contract<sup>16</sup> and the third party lender was without the pale of the negligence.

In *Ultramares* Justice Cardozo made his famous observation to the effect that a favorite subject for juridical discussion was the assault upon the citadel of privity. Today, this citadel resembles a Druid ruin. Even in the area of professional standards, privity has suffered a minor breach in that an architect has been found to be liable to a surety for excess progress payments made by an owner to a contractor upon the architect's evaluation of labor and materials furnished. Privity was not present between the architect and the surety.<sup>17</sup> Also, liability apparently exists without

15. *Id.*, 174 N.E. at 444.

16. *Ultramares Corp. v. Touche*, *supra* note 14.

Our holding . . . does no more than say that, if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is none that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more.

*Id.* at 448.

17. *Peerless Ins. Co. v. Cerny & Associates, Inc.*, 199 F. Supp. 951 (D. Minn. 1961). The architect (defendant) had actual or constructive notice of the surety bond.

Such knowledge added to by the duty of defendant to exercise reasonable care in certifying bills for payment, as it did, charged defendant with notice that the retainage fund was not to be released until the contract had been carried out and concluded, as provided therein, requiring the contractor to submit satisfactory proof that all bills and indebtedness had been paid. Privity of contract between plaintiff and defendant was not a pre-requisite to the existence of the defendant-architect's duty in the foregoing respect, for the reason that said architect's duty to protect the owner and the subrogated surety arose out of the general and mutual contractual arrangements which included resulting independent rights and obligations. Nor is privity of contract a requisite to make effective said duty, the violation of which constitutes actionable negligence.

To state it otherwise, defendant-architect understood the performance of professional conduct, which, if negligently performed, would obviously cause loss to the owner and/or plaintiff-surety. Under such circumstances, the law imposes upon defendant a duty to exercise due care to avoid such loss . . . .

*Id.* at 954.

privity between a pipeline owner and an engineer if the engineer negligently inspects pipe,<sup>18</sup> and to a subcontractor if an engineering firm negligently omits pertinent information.<sup>19</sup>

As a generalization, however, courts refuse to extend tort liability beyond the immediate employer in the negligent audit type cases.<sup>20</sup> The limit of liability drawn so expertly by Cardozo in *Ultramares* has remained essentially inviolate for 35 years in spite of the destruction of the citadel in the field of products liability.

In response to the plea of privity, *T* Bank could argue that the anachronistic wall of privity separating the protected from the unprotected should be subject to judicial relocation upon logical and plausible grounds. That while not advocating recovery without privity in every instance of negligent professional certification, certainly the first rank of reliance should be protected from the negligence of the incompetent professional. That, as in other areas of negligence, the injury to *T* Bank was a natural and probable consequence of the negligent evaluation and that the parties to the purchase transaction would act to their detriment should have been easily foreseen by *Cursory*. That neither time, nor amount, nor class is so indeterminate as to absolve the negligent professional engineer from the consequences of his act. *T* Bank would have support in this theory by application to the *Texas Tunneling Co.* decision.<sup>21</sup> The bank could also allege that *Cursory* was in the business of measuring and certifying oil and gas reserves and was, therefore, liable upon the doctrine of *Glanzer v. Shepard*.<sup>22</sup> However, the *Glanzer* opinion appears to have been limited by subsequent decisions and may be a doubtful premise.

18. *Getty Oil Co. v. Mills*, 204 F. Supp. 179, 187 (W.D. Pa. 1962): "We are convinced that the lack of privity of contract between plaintiff and defendant does not absolve defendant from tort liability to plaintiff if the inspection were negligently performed."

19. *Texas Tunneling Co. v. City of Chattanooga*, *supra* note 6.

20. *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d (1938); *O'Connor v. Ludlam*, 92 F.2d 50 (2d Cir. 1937), *cert. denied*, 58 U.S. 364; *American Cas. Co. v. Memorial Hosp. Ass'n.*, 223 F. Supp. 539 (E.D. Wisc. 1963).

21. *Texas Tunneling Co. v. City of Chattanooga*, *supra* note 6.

22. *Glanzer v. Shepard*, 233 N.Y. 236, 135 N.E. 275, 23 A.L.R. 1425 (1922). *A* sold 900 bags of beans to *B*. *A* requested *C* to weigh the beans and issue a certificate of weight. *C* was to send the original certificate to *A* and a copy to *B*. *C* erred in the weighing and *B* paid *A* based upon the erroneous weight. *B* then sued *C* alleging negligence. *B* was allowed to recover. Justice Cardozo made the following points in the decision: (1) Plaintiff's

Assuming for a moment that *T* Bank was successful in penetrating the privity barrier, it would seem that Cursory would have a commendable defense, no matter how uncommendable its evaluation, in asserting that the failure of the reserves was a function of *B*'s production practices. This being a possible defense, should *T* Bank join *B* and Cursory?

The lending documents supporting the reservation of the oil payment would furnish the privity necessary between *T* Bank and *B* and would undoubtedly contain numerous covenants concerning the operation of the properties.<sup>23</sup> *T* Bank could allege violation of the covenants by *B*'s producing practices and assert a claim of negligence and breach of contract. Without privity could *B* join Cursory as a third party defendant alleging the lack of production was caused by improper evaluation of reserves rather than improper production methods?

As a digression, suppose that *A* sold the properties for considerably less than their then present worth based upon Cursory's incorrect evaluation, would *A* have a meritorious claim against Cursory?

Be that as it may, if Cursory successfully resurrects the ramparts of privity as a defense for professional negligence, the next consideration would be fraudulent representation.

In 37 C.J.S. *Fraud* § 3, at 215 (1943) it is stated:

The elements of actionable fraud consist of: (1) a representation, (2) its falsity, (3) its materiality, (4) the speaker's knowledge of its falsity and/or ignorance of its truth, (5) his intent that it should be acted on by the person and in the manner reasonably contemplated, (6) the hearer's ignorance

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use of the certificate was not an indirect or collateral consequence but one which to the weigher's knowledge was the end in aim of the transaction. (2) One who follows a common calling may come under a duty to another whom he serves, though a third person may give the order or make the payment. (3) Defendants did not merely use careless words but carelessly performed a service—the act of weighing—and then carried it in writing. The court concluded by saying: "The defendants, acting not casually nor as mere servants, but in the pursuit of an independent calling weighed and certified at the order of one with the very end in aim of shaping the conduct of another. Diligence was owing, not only to him who ordered, but to him also who relied." *Id.* 135 N.E. at 277.

23. In the conveyance from *A* to *B* of the producing properties, the oil payment is reserved by *A*. This conveyance (*A* to *B*) typically contains positive covenants concerning the operation of the properties by *B*. *A* then assigns the reserved oil payment with protective covenants to *C*, who in turn assigns payment and covenants to the lending bank.

of its falsity, (7) his reliance on its truth, (8) his right to rely thereon, (9) and his consequent and proximate injury.

Another statement from the same source is:

That to constitute actionable fraud it must appear: (1) that defendant made the material representation, (2) that it was false, (3) that when he made it he knew that it was false, or made it recklessly without any knowledge of its truth and as a positive assertion, (4) that he made it with the intention that it should be acted on by plaintiff, (5) the plaintiff acted in reliance on it, (6) that he thereby suffered injury.<sup>24</sup>

Another authority defines the elements to sustain an action for deceit as being:

That a representation was made as a statement of fact, which was untrue and known to be untrue by the party making it, or else recklessly made; that it was made with intent to deceive and for the purpose of inducing the other party to act upon it; and that he did in fact rely on it and was induced thereby to act to his injury or damage.<sup>25</sup>

Therefore, at the outset our inquiry is whether a reserve evaluation is a material, false, representation of fact, or a mere statement of opinion. The former would sustain a cause of action, the latter would not.<sup>26</sup>

The question of fraud emanating from statements concerning the future production from oil and gas properties has been considered between a buyer and a seller on several occasions and it has been stated that: "Nothing is more uncertain than the production of oil wells, and any repre-

24. 37 C.J.S. *Fraud* § 3, at 217 (1943).

25. 23 AM. JUR. *Fraud & Deceit* § 20 (1939).

26. 37 C.J.S. *Fraud* § 10, at 226 (1943):

The general rule is that a mere expression of opinion or a belief or more precisely a representation which is expressed and understood as nothing more than a statement of opinion, cannot constitute fraud. To be actionable, a false representation must be one of fact as distinguished from an expression of opinion, which ordinarily is not presumed to deceive or mislead, or influence the judgment of the hearer, and on which he has no right to rely, since he is assumed to be equally able to form his own opinion. Thus there can be no redress for error in representations which are expressed and understood as mere estimates or judgments, as to, for example, the capacity of a well, the speed of a horse, the value or character of a building, or the population of a city.

sentation as to future production is a mere expression of opinion as to expectations and probabilities and will not constitute fraud, even though it turns out to be untrue."<sup>27</sup>

However, opinion stated as fact<sup>28</sup> or an opinion of an expert<sup>29</sup> may furnish a sufficient basis for an action for fraud. In *Baker v. Moody*<sup>30</sup> a lower court instructed the jury that: "A statement as to how many barrels of oil a well will, or will not make, is not a statement of presently existing facts, or, a promise of anything to happen in the future, but, is merely an opinion, and not the basis of fraud."<sup>31</sup> The appellate court held this instruction to be incomplete and noted that the jury should consider all the circumstances and the evidence as a whole and decide whether the defendants intended that the plaintiff should act on the falsity.

Also, if the misrepresentations relate to extrinsic facts materially affecting value and the facts are peculiarly within the seller's knowledge, an opinion statement by such a seller may gain the status of being sufficient to found an action in fraud.<sup>32</sup>

Referring to the hypothetical situation, we may transmute the negligence of the incorrect reserve report into the initial elements of a cause for fraud. The report (1) may constitute a representation whether it is viewed as an expert opinion or as an opinion stated as fact, (2) is demonstrably false as shown by subsequent performance, and (3) since the reserve report is the foundation document of the transaction its materiality may be assumed.

While Cursory may not have had actual knowledge of the falseness of its report, if Cursory's positive assertion

27. *Engemann v. Allen*, 201 Ky. 483, 257 S.W. 25, 2 6(1923); *Krumholz v. Goff*, 315 F.2d 575 (6th Cir. 1963). In the latter case the buyer also obtained the following warranty: "First parties represent and warrant that the daily production in this lease is approximately 400 barrels per day and second parties rely upon said warranty and representation in entering into this agreement." *Id.*, 257 S.W. at 26. Production was not 400 barrels as represented and "second parties" attempted to rescind. The court held that since the "second parties" investigated the production and knew production was below 400 barrels at the time of purchase there was not sufficient breach of warranty to allow them to rescind.

28. *Finke v. Boyer*, 331 Mo. 1242, 56 S.W.2d 372 (1932); *Stonemets v. Head*, 248 Mo. 243, 154 S.W. 108 (1913); *Ultramares Corp. v. Touche*, *supra* note 14.

29. 37 C.J.S. *Fraud* § 10 (1943); *Ultramares Corp. v. Touche*, *supra* note 14.

30. 219 F.2d 868 (5th Cir. 1955).

31. *Id.* at 371.

32. *Hotaling v. A. B. Leach & Co.*, 214 N.Y.S. 452 (1926).

was made recklessly and without knowledge of its accuracy, a sufficient basis is also provided for the theory in fraud.

In *Ultramares* Cardozo summarized that:

Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself.<sup>33</sup>

The pale then of fraud is far more extensive than that of negligence and the duty may extend at least to the first line of lenders and possible purchasers. Cardozo also noted that negligence, and in particular gross negligence, may support an inference of fraud.

Considering the whole of the hypothetical and the elements of fraud established, the transmutation to fraud is relatively complete. Also, if the causes of action for fraud and negligence are coalescing as appears to be the result in the *Texas Tunneling Co.* decision,<sup>34</sup> *T* Bank would be able to establish a credible cause for recovery upon either a fraud theory or upon a combined negligence-fraud basis.

The certificate of Cursory should be considered briefly in passing as a possible defense. Cursory certified that it had evaluated the property based upon information supplied by the seller, utilizing sound and accepted engineering practices.

In *Texas Tunneling* the court considered an express disclaimer which provided that the information was not guaranteed and any bids submitted should be based upon the bidder's own investigations and determinations. The court held that since it was customary for contractors to rely on such information the disclaimer would not eliminate the duty of due care.<sup>35</sup> However, a certificate providing notice of reliance upon external sources may absolve the certifier from liability if the error is traceable to the external source.<sup>36</sup> It would seem

33. *Ultramares Corp. v. Touche*, *supra* note 14, 174 N.E. at 444.

34. *Texas Tunneling Co. v. City of Chattanooga*, *supra* note 6.

35. *Id.*

36. *Beardsley v. Ernst*, 47 Ohio App. 241, 191 N.E. 808 (1934).

that regardless of the verbiage of the certificate and the scope of the disclaimer, if the investigation preceding the certificate was negligently or fraudulently accomplished, it is probable that the certifier will find slight, if any, shelter behind the language of its certificate.

The course to recompense that must be traced by the lender is tenuous at best and it would seem the size of the equity payment demanded by the lender is the most accessible vehicle for the protection of the loan. Should the oil and gas reserves fail to provide sufficient revenues to amortize a loan secured by a reasonable advance equity payment by the borrower, the evaluating firm should be held accountable. If the loss was to be caused by the failure of the lender to demand a sufficient cash cushion for the loan or, stated conversely, by the lender advancing an excessive amount against oil and gas reserves which must be universally known to be estimates and not absolutes; then the lender, by failing to protect its own interest, should suffer the resultant loss.