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The legal implications of failing to continue a Crown oil and gas lease: the duty of the operator to its joint operators and to the holder of a royalty interest

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Cases Considered:

Adeco Exploration Company Ltd. v. Hunt Oil Company of Canada Inc. 2008 ABCA 214, varying unreported oral reasons for judgement of May 3, 2007.

One of the most important events in the life of a Crown oil and gas lease or licence in Alberta is the point of continuation at the end of the primary term (a lease) or at the end of the intermediate term (a licence). It is important because a lease or licence lapses at the end of its primary or intermediate term except to the extent that it is continued (*Mines and Minerals Act*, R.S.A. 2000, c. M-17, s.82(1)). And when a lease lapses as to some or all of the leased area so too will any royalty interests with respect to that area of the lease.

The current rules on continuation are prescribed in the *Petroleum and Natural Gas Tenure Regulations* (Alta. Reg. 263\1997). They are applied on a spacing unit by spacing unit basis. If there is a well capable of production on any spacing unit within the area of the Crown lease, that spacing unit is continued down to the deepest formation capable of production (*Tenure Regulations* s.15(1)(a))

But where the spacing unit has not been drilled out and the spacing unit is not included within the area of a unitization agreement, the lease\licence will only be continued for that spacing unit to the extent that the lessee (and in particular the authorized representative of the lessee since in a co-owned well the Crown wants to know with whom it has to deal) can show to the satisfaction of the Department that the spacing unit is capable of production (s.15(1)(e)). This makes sense in societal terms. We do not want to encourage the drilling of unnecessary wells since each well increases the ecological footprint of the industry and the capital spent on each well potentially dissipates the amount of economic rent that the Crown can collect. So if our lessee can show by drill results and mapping that the spacing unit would be productive if drilled and that the reserves underneath that spacing unit are in fact being produced from offsetting wells also on Crown property then that spacing unit will be included in the continuance decision. But outside the spacing unit of the producing well(s) the onus is clearly on the lessee to adduce the evidence before the Department to make that case.

And to aid the lessee\licensee in that endeavour the Department produces a number of information letters and guidelines and offers the lessee the opportunity to meet with Departmental staff to allow the lessee to make its best case with whatever information it has available: (e.g. Information Letter, IL 2008-13 Continuation of Petroleum and Natural Gas Leases and Intermediate Term Licences, Continuation Application Guide and Technical Guidelines for Continuation.) And these documents emphasise that certain types of information are "useful" in support of an application whereas others are "essential". Amongst the data described as essential to support an application under s.15(1)(e) of the *Regulations* is mapping, isopach, net pay or structural mapping with supporting cross sections as appropriate.

So what happens if the authorized representative of the lessee fails to put its best foot forward in a case such as this and, as a result, the Department authorizes continuance for the drilled spacing units but fails to authorize continuance for the undrilled spacing units in the lease? May the representative be liable to its co-owners? And may the representative be liable to a party with a royalty interest? And if the answer is "yes" in either case on what basis – contract, tort, co-ownership obligations or fiduciary duty?

These were the issues in *Adeco v. Hunt* and the courts found Hunt liable both to its co-owners (Adeco (A) and Shaman(S)) and to the royalty owner (Rama) on the basis of breach of contract. Assessment of damages will follow.

The facts

The facts were basically as outlined above; Hunt held a 75% interest in two leases, Adeco a 16.66% interest and Shaman an 8.33% interest. The leases were subject to a JOA that used the 1990 CAPL (Canadian Association of Petroleum Landmen) form. Rama held a 3% overriding royalty interest which it obtained in return for bringing these properties to the attention of Hunt et al. There was an undrilled spacing unit on each of the leases. Hunt waited until the last day to file its application for continuation but prior to that it had confirmed with A & S that the application should include the undrilled spacing units. Hunt included well logs and recent production data in support of the application but did not include an interpretive map. Three months later the Department wrote back indicating that it would continue for all the leased lands except the undrilled spacing units but it did advise Hunt that it could supply additional data to support its application for these two parcels within a month. Hunt made internal inquiries, determined that it had no further information to submit and as a result did not submit further supporting information. Hunt did provide a copy of the Department's letter to A & S. Subsequently when the lands were put up for bid Hunt submitted an offer to reacquire the lands but was unsuccessful. At trial, evidence was led tending to show that the lease would have been extended as to these two units had Hunt provided supporting mapping and that the preparation of such a map should have been a relatively straightforward exercise based on information that Hunt would have had to hand.

In addition to the 1990 CAPL Agreement, the royalty agreement between all of the parties included: (1) a grantor's covenant to make all required payments etc. and to keep the leases "not

[to] allow the Said Leases to terminate or become subject to forfeiture"; (2) a covenant not to surrender the leases or any portion thereof without providing Rana with notice and an opportunity to take an assignment, and (3) a liability and indemnity covenant in which the grantors acknowledged liability and a duty to indemnify for all losses, damages, costs etc incurred by Rama as a result of "any act or omission … with respect to operations or activities conducted by [the grantor]".

Judgement at trial

The trial judge (Justice Miller) in short oral unreported reasons concluded that Hunt had breached its obligations to A & S under cl. 309 of the 1990 CAPL to maintain the title deeds and that Hunt was not exonerated from this liability by cl. 401 (which purports to limit the operator's liability to its joint operators except in cases of gross negligence or willful misconduct). Justice Miller also held that Hunt was in breach of a fiduciary duty which it owed to each of the defendants – Rana, A & S. And finally, Justice Miller held that Hunt was liable to Rana on the terms of the royalty agreement and rejected Hunt's effort to third party A & S to reduce its direct liability to them on the basis of contributory negligence and to have them share the contract-based joint and several liability of the grantor to Rana under the terms of the royalty agreement.

Judgement on appeal

The limitation on liability

In a unanimous reserved judgement for the Court of Appeal Justice Keith Ritter (writing also for Clifton O'Brien and Patricia Rowbotham JJ.), confirmed the result reached at trial but for rather different reasons. Unlike Justice Miller the Court of Appeal concluded that the cl. 401 successfully excluded the operator's liability for damages suffered by joint operators as a result of negligence. This exclusion of liability did not just apply to the cl. 304 duty to conduct all joint operations diligently in a good and workmanlike manner, in accordance with good oilfield practice but extended to other specific contractual duties such as the cl. 309 duty to maintain the title documents in good standing.

I think that this is absolutely correct. Unlike the situation in a farmout where the farmee conducts the operation at its sole cost, risk and expense, all operations (except independent operations) conducted under the operating agreement are shared risk operations. The parties assume some risk of negligence and the operator is not an insurer of that risk.

In reaching this conclusion the Court referred to Justice Hunt's judgement in *Erehwon v, Northstar* ((1993), 108 DLR 4th 709) and her distinction between liability as between the parties to the agreement (operator liable for mere negligence) and liability arising from a loss suffered by a third party (liability for the joint account unless operator grossly negligent) but did not overrule her approach. Instead the Court preferred to distinguish *Erehwon* on the basis that it was a decision on the 1981 CAPL and that the 1990 CAPL demanded a different result because it distinguishes clearly between liability and the duty to indemnify (at para. 42).

It is not clear to me that it is possible to distinguish *Erehwon* quite so easily. Notwithstanding the Court of Appeal's decision in *Mobil Oil v. Beta* (1974), 43 DLR (3d) 745 there is nothing about the concept of indemnity that confines it to the third party situation (*TransCanada Pipelines v Potter Station Power* [2003] OJ 1879). It may simply be the case that the agreement does not support the distinction that Justice Hunt made in *Erehwon* and if the industry wants to make that distinction it will need to do so in the drafting of the CAPL Agreement. It seems to me that this is precisely what the drafters of CAPL 2007 have tried to do (see the new cl. 4.01).

The gross negligence standard

While this conclusion certainly served to correct Justice Miller's (mis)interpretation of the 1990 CAPL it left outstanding the question of whether or not Hunt might still be liable for the loss of part of the lease on the basis that its failure to prosecute lease continuance was not merely negligent but was actually grossly negligent. One might have thought that this was an area in which an appeal court would be loath to tread since this is mixed fact\law issue and the standard for review is that of palpable and overriding error. But it must be appreciated that in this case the trial judge had not made a determination on this point since he didn't need to. Justice Miller took the view that mere negligence was enough to ground liability and did not address himself to the question of gross negligence. That, as Justice Ritter noted (at para. 49) left the Court of Appeal with two options, send it back to trial or decide the question on the basis of the existing record. The court plumped for the second option and on the basis of its assessment of the record concluded that Hunt Oil was indeed grossly negligent.

The Court's approach to this question followed four steps. First, the Court examined just what it was that Hunt had done or had failed to do. Here (at paras 50 – 54) the Court noted that: Hunt left everything until the last day (not itself evidence of even negligence); upon receipt of the deficiency letters the relevant employee made some further inquiries but concluded that there was no further information available to file; the case was an easy case, "a simple matter" and, contrary to what Hunt's employee had concluded, the information was available or could have been produced with minimal effort; the relevant instructions were readily available on the web; Hunt had an internal system that worked when all went well but was woefully inadequate to deal with any situation where a problem was encountered.

The second step in the reasoning was for the Court to conclude that all of the above taken together amounted to negligence (at para. 55).

The third and crucial step was to move from a negligence categorization to a gross negligence categorization. As part of that the Court analysed some of the case law dealing with the gross negligence standard (at para. 55) drawing upon two cases dealing with the liability of municipal governments, one gratuitous passenger case, one oil and gas law case from Alberta and one case from Texas. From these cases emerged such key phrases as "very great negligence", "conscious wrongdoing". "marked departure" from the required standard, and "conscious indifference". Relevant questions to ask as part of the analysis include the character and duration of the neglect and the comparative ease of discharging the duty.

And as a fourth step the Court applied these dicta to the facts holding that Hunt's system for dealing with continuance was not just flawed, "it did not come close" to what was required (at paras 56 and 57):

> [56] Hunt Oil argues it was not consciously indifferent since it had a system for renewal in place. However, as I have stated, that system involved a great deal of *ad hoc* response to crises by personnel lacking requisite knowledge and skills. It was a system that contemplated no problems, and no doubt worked so long as the continuation involved leases on producing lands. It did not come close to addressing what was required for continuations on non-producing lands.
> [57] What Hunt Oil did may be likened to a system in a law office in which an untrained, unknowing person, tasked with ensuring claims are filed in time to meet limitations, upon having a claim rejected by the relevant filing office, checks with someone else, who has no understanding of the process. In turn, the person checked with either provides a response that we are doomed, or, checks with another person who erroneously provides that response. I would have no hesitation in determining the responsible lawyer or firm to be grossly negligent in relying on such a system. It amounts to no system at all. It relies on luck to ensure that claims are filed in time.

This is likely the part of the judgement that will receive the greatest degree of scrutiny (notwithstanding the fact-specific nature of any gross negligence finding) simply because any finding of gross negligence will eviscerate the carefully constructed limitation on liability that the CAPL 1990 has created for the operator. So, is the analysis convincing? Is the limitations analogy appropriate? What is it that actually helps us draw the line between ordinary and gross negligence? Has the Court offered any real guidance on this question or is it simply a case of "we know it when we see it"? And how large is the category of gross negligence?

I don't propose to try and answer all of those questions here but my sense is that the category of negligence is large and the two paragraphs quoted above come dangerously close to saying that the operator must get it right (even where questions of interpretation are involved) and that anything short of that is not just negligence but gross negligence. One way to think about it this is to ask what Hunt would have had to have done to avoid the label of gross negligence? It seems that Hunt needed to have in place a system for maintaining title for properties for which it is the operator that have the following characteristics: (1) the system must ensure that all applications for continuance are filed in a timely way, (2) the system must ensure that such an application meets the requirements of the regulations or if it fails to do so and the operator has a chance to supplement the application it needs to have in place a system that would generate a correct response, at least in an easy case. If this even comes close to capturing the standard of conduct expected of the operator by the court to avoid attracting the epithet "gross" then the umbrella of protection that the court has just re-affirmed in its interpretation of clause 401 seems very narrow.

Contributory negligence

Because of the finding of fact made by the trial judge (that Hunt had not in fact delivered all the supporting material for the continuance application to its co-owners) Hunt was left to make the argument on appeal that A & S contributed to the loss themselves by failing to make sure that Hunt acted upon the opportunity to present additional evidence to the Department. The trial court had rejected that argument holding, in effect, that A & S were entitled to assume that Hunt would do its job and protect their interest. The Court of Appeal held (at para. 60) that there was no palpable and overriding error in this assessment of A & S's behaviour.

But I wonder if there is not a logical inconsistency here. If it really is the case that an operator is protected from liability for mere negligence, how can the joint operator ever simply be able to assume that the operator will act as a "good operator" (and see also para. 73) and protect its interest? There is something to be said for the idea that if the joint operator sees something going awry then it should take at least some minimal steps to ensure that the operator is put back on the straight and narrow.

The same result followed in relation to Hunt's efforts to have A & S contribute to the liability owed to Rana for loss of the royalty interest. That liability was *prima facie* a contract-based joint and several liability that Hunt should have been able to share. But the result here is that Hunt is effectively required to indemnify its partners with respect to this liability. Precisely how we get to that conclusion is less than clear. In the brief discussion (at para 75) there is the suggestion that the conclusion flows from the fact that the royalty agreement "was amended or altered" and had "imposed on it the terms of the JOA" including cl. 401 and its gross negligence exception.

The fiduciary duty issue

Any fiduciary duty case in the context of the oil and gas operating agreement raises at least three separate questions: (1) is there a fiduciary duty, (2) what is the content of the duty, and (3) has the duty been breached.

As to the first question there is of course a lot of case law glibly asserting that the operator is a fiduciary for the joint operator. The cases include *Powermax v Argonauts* [2003] ABQB 4, *Great Northern Petroleums v. Merland* (1984), 36 Alta. LR (2d) 97, and *Bank of Nova Scotia v. Societe Generale,* [1988] 4 WWR 232. But the glibness is misleading. The operator is not one of the *per se* categories of fiduciaries like the trustee\ beneficiary and the agent\principal[1] so each case

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1 But here of course there was *de facto* an agency relationship by virtue of both the language of 309 (act on behalf of the parties and for the joint account) and the designated representative requirement of the regulations. But even if that sufficed to make the operator a fiduciary in relation to this particular matter there was no breach of the duty to self deal; at most there was a failure to take adequate care which takes us back to negligence and the scope of the limitation on liability. Neither court refers to the law of co-ownership. But the starting point in a co-ownership situation is that there is no fiduciary duty as between the parties: *Kennedy v. De Trafford* [1897] AC 180 HL(E)). But as *Kennedy* recognizes, a co-owner may assume greater responsibilities if it agrees to act as a bailiff\property manager. The duties in relation to the title documents have some of these property management characteristics.

requires what Justice La Forest (dissenting on this point) referred to in *Lac v. Corona* [1989] 2 SCR 574 as an examination of the relevant facts and circumstances. That examination is informed by an assessment of the purpose of the fiduciary classification which is to protect vulnerable persons. But vulnerability alone is not enough. There must also be an assessment that it is reasonable to expect that the person to be classified as a fiduciary will put aside their self interest and act instead in the best interests of the fiduciary (or in the case of a partnership or a joint venture, that entity): *Hodgkinson v. Simms*, [1994] 3 SCR 377. And it is this latter that is, and appropriately so, the principal stumbling block to imposing a fiduciary obligation in a commercial context since a duty of undivided loyalty owed to another is hardly the stuff of commercial relationships: *Luscar v. Pembina* [1995] 2 WWR 153.

As for the content of the duty, the principal duty owed by a fiduciary is the duty of undivided loyalty, the duty to avoid even being placed in a position where (self) interest and duty conflict (*Keech v. Sandford* (1726) 2 Eq. Cas. Abr. 741). But the fiduciary also owes a more general duty which is the duty to take that care of the asset (in relation to which it owes a fiduciary duty) that a reasonable person would take of their own property (*Fales v. Canada Permanent Trust Co*, [1977] 2 SCR 302; *Blueberry River Indian Band v. Canada* [1995] 4 SCR 344).

But there is a tendency to conflate the first two of these three questions and that seems to have happened here in both the trial judgement and that of the Court of Appeal. Justice Miller at trial concluded that Hunt owed and was in breach of a fiduciary duty to each of A & S and Rana with little more than a recitation of the well worn three-part test from *Frame v Smith*, [1987] 2 SCR 99. The Court of Appeal rightly castigated that as entirely inadequate and undeserving of any degree of deference (at para. 66) but the Court's own conclusion for rejecting Justice Miller's conclusion might have been better reasoned.

In effect the Court of Appeal found that there was no fiduciary duty here because Hunt's conduct was not willful and that the courts generally only impose a fiduciary duty where there is both vulnerability and "intentional conduct". In this context intentional conduct seems to be little more than a generalized reference to the issue of whether or not Hunt was in breach of a duty of undivided loyalty. But how did we get to that point? The first question should have been did Hunt owe a fiduciary duty? And while the Court found all three of the plaintiffs to be vulnerable (at para. 73) the Court never inquired as to whether it was reasonable to think that Hunt would put aside its self interest. But in a sense that question was irrelevant because the facts of this case never raised an issue of self dealing. The party that suffered the most here from the failure to make a proper application was Hunt itself. The only element of the fiduciary duty analysis that was ever going to have any bite was the general duty of care owed by a fiduciary which is perhaps why the Court should not have been so quick to conclude (at para. 64) that clause 401 limiting the liability of the operator did not extend to breaches of fiduciary duties. Perhaps the Court's conclusion is obvious in relation to duties flowing from the undivided duty of loyalty; but it is less obviously so in relation to the fiduciary's duty of care

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