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When is a non-operator entitled to a constructive trust over the operator's own assets?

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Cases Considered:

Brookfield Bridge Lending Fund Inc. v. Vanquish Oil and Gas Corporation, 2008 ABQB 444

In this case Justice Bruce McDonald ruled that a joint operator may be entitled to a constructive trust remedy over the assets of an operator, where the operator is in receipt of production revenues attributable to the joint operator and where the operator fails to preserve an amount representing those monies in its commingled bank account. As a result, the joint operator was allowed to take priority over the interests of both secured and unsecured creditors.

The facts

Karl (55%) and Choice (45%) owned interests in the Simonette property. Karl was the operator and sold its entire interest to Vanquish whereupon Vanquish assumed the role of operator. On March 28, 2007 Vanquish was placed in receivership by Brookfield, a secured lender of Vanquish. The receiver sold the property retaining an amount in reserve to stand in place of Vanquish's assets in relation to Choice's claim to production revenues (in fact, and in another action, Karl also made a claim to those revenues on the basis that Choice had forfeited its interest, but for the purposes of this decision and my comment nothing turns on that point). Vanquish had not remitted production revenues to the joint operator and the amount outstanding was estimated as $320,539.

The property was subject to the Canadian Association of Petroleum Landmen (CAPL) 1990 operating procedure and its clause 507 which expressly authorizes the Operator to commingle its own funds with monies received from or for the account of the joint operators. The clause goes on to provide that joint operator monies, whatever the source, "shall be deemed to be trust moneys and shall be applied only to their intended use and shall in no way be deemed to be funds belonging to the Operator, other than in its capacity as the Joint-Operator's trustee."

Vanquish maintained a main operating account and all its transactions moved through that account. Relevant balances were as follows: March 14, balance of $40,218; March 14, cheques written for $202,267; March 16, a further amount of $40,598 credited to the account as production from Simonette.

The issue before the Court was whether Choice had a claim in trust against other assets of Vanquish to the extent of the unpaid production revenues. Vanquish argued that Choice's claim should be confined to the amount remaining in the joint account at the time of the receivership, at most some $58,000.

The judgement

Justice McDonald held that the assets of Vanquish (and the proceeds of sale of any such assets) were subject to a constructive trust in favour of the 45% non-operator working interest of the owner of the Simonette property.

Had Vanquish followed the instructions of cl. 507, the full amount owing to Choice would have been in Vanquish's general account impressed with an express trust. This would have afforded Choice a priority against Brookfield. By failing to preserve the full amount of these production revenues in its commingled general account Vanquish was in breach of trust and in breach of its fiduciary duties.

In order to remedy that breach of trust it was appropriate to impose a constructive trust on the assets of Vanquish to the extent of unpaid production revenues on the grounds that: (1) cl. 507 of the CAPL imposed an express trust, (2) Vanquish's remaining asset base was enriched by the breach of trust, (3) it was appropriate to grant a proprietary remedy to ensure that persons in Vanquish's position fulfilled their trust obligations under cl. 507, and (4) it was not unjust to impose a constructive trust in this case having regard to the interests of a secured lender since the secured lender is in a strong position to ensure that its customer adheres to its obligations by employing such things as borrower's covenants, reporting procedures etc. (applying *Soulos v. Korkontzilas*, [1997] 2 SCR 217).

Assessment

Some twenty years ago the Alberta Court of Appeal in a decision known as the *Sorel Resources* case, or more formally as *Bank of Nova Scotia v Société Générale (Canada) et al* [1998] 4 WWR 232 decided that the right and power of the operator under the 1981 version of the CAPL operating procedure to commingle excess AFE (authorization for expenditure) monies and joint operator production revenues with its own monies in a general bank account, was not itself fatal to the claim that these monies were impressed with a trust. In fact, on very slim evidence, the Court found that the 1981 CAPL agreement created not just a fiduciary duty in relation to these monies but an express trust. I have always thought that *Sorel Resources* was wrongly decided. The relevant clauses of the 1981 CAPL agreement did not use the language of trust. This was a case in which the Court used the trust label in order to provide the plaintiffs with an effective remedy without seriously considering whether they were entitled to such a remedy. In sum, I thought that the Court was asking itself the wrong question. I thought that the Court should have been asking itself this question: is it appropriate to grant these plaintiffs (joint operators with respect to shared risk operations) an equitable proprietary remedy so as to prevail against both secured and unsecured lenders?

Fast forward to the present and the current decision on the 1990 CAPL form. The provision of the 1990 CAPL form on the right and power of the operator to conduct operations for the joint account using a commingled general account is a "have your cake and eat it" provision. The provision seeks to make it crystal clear that excess AFE monies and production revenues are trust monies. And, unlike the 1981 version, we must all concede that this does amount to a declaration of an express trust. But the clause also permits the commingling practice, no doubt because of the convenience factor. Imagine if every operator of every single separately owned oil and gas property in the province (and remember there may be many separately owned properties with different ownership positions within the confines of a single lease) had to maintain a separate trust account for each of these properties.

But commingling as used in the 1990 CAPL form does not allow an operator to spend those monies since they are trust monies. But given the fact of commingling of a completely fungible commodity the operator cannot have a duty to preserve those specific monies. Instead, presumably what the trustee must do is to ensure that it never draws down its commingled account below the level of its cumulative trust commitments - potentially in relation to multiple properties. If the operator does not succeed in doing that it is in breach of trust. And if it is in breach of trust we must consider the question of an appropriate remedy for the joint operator who, as here, finds that the larder is empty.

One remedy that our operator (and the board of directors of that operator) should have clearly in mind are the provisions of the *Criminal Code* (s.336) dealing with theft by a trustee and criminal breach of trust. But those provisions provide little comfort to the joint operator who is interested in getting its money back rather than incarceration. For the joint operator, the empty larder is hugely problematic especially if there is no possibility of a tracing remedy. In this case, creative counsel hit upon the remedy of constructive trust; a constructive trust over assets of the operator other than those already burdened by the express trust. And this time, I think that the Court did ask itself the correct questions or at least some of them, because it is apparent that the Court, following both Justice LaForest's judgement (for the majority on this point) in *Lac Minerals Ltd v. International Corona Resources Ltd* [1989] 2 SCR 574 and *Soulos* (supra) did ask whether an equitable proprietary remedy was appropriate in these circumstances.

The real question then is whether we got the correct result on the application of the relevant tests? In my view Justice McDonald has been too solicitous of the interests of the joint operator and has not accorded enough weight to the exceptional nature of the constructive trust remedy.

In his judgement Justice McDonald focused on the *Soulos* decision in determining whether it was appropriate to award an equitable proprietary remedy. It is at least questionable how relevant *Soulos* should be on these facts. The principal issue in *Soulos* was whether or not it was appropriate to grant an equitable proprietary remedy in the absence of an unjust enrichment. Here I think that it is fairly clear that Vanquish was unjustly enriched by appropriating trust assets. And, if Vanquish had used those trust assets to purchase other specific properties, there is little doubt but that a constructive trust would have attached to those specific properties. The real question in this case is whether a constructive trust should attach to any other properties of the

trustee in the absence of a clear connection or nexus between the breach of the express trust and the specific assets to which the constructive trust will apply. That was not an issue in *Soulos*. In that case the very property purchased by the realtor was the specific property that was the subject of the fiduciary relationship.

It seems to me that Justice McDonald glosses over this question and he does so in his application of the first and second criteria from *Soulos*. These criteria read as follows:

> (1) The defendant must have been under an equitable obligation, that is, an obligation of the type that courts of equity have enforced, in relation to the activities giving rise to the assets in his hands;
>
> (2) The assets in the hands of the defendant must be shown to have resulted from deemed or actual agency activities of the defendant in breach of his equitable obligation to the plaintiff;

In the present case, Choice seeks to establish a constructive trust over the operator's interest in the lands (and perhaps other assets as well, the judgement is less than clear as to the subject of the constructive trust). The problem is that the defendant, Vanquish, owes *no* equitable obligation "in relation to the activities giving rise to the asset [the working interest] in his hands". Vanquish owes an equitable obligation in relation to production and the proceeds of production from the lands attributable to Choice, but it owes no equitable obligation with respect to its own lands or its own share of production. Similarly, there is nothing to suggest under the second criteria that the assets (Vanquish's working interest and perhaps other assets) are in Vanquish's hands as the result of the breach of an equitable obligation. In fact, the asset was in Vanquish's hands because Vanquish purchased them from Karl and it is not enough simply to suggest that Vanquish's net asset base has been enriched by Vanquish's breach of trust.

There is a reason why the matter of nexus is important. It is important because one of things that the person seeking the constructive trust has to show is that it is just that that person receives the additional benefits that flow from the right to property - not just any property but some specific property. The plaintiff must have some special claim to that property even if, as Justice LaForest says in *Lac*, it is not necessary for it to establish a "pre-existing right of property". The need for a nexus also informs the rules of tracing; and if a plaintiff cannot trace it is not immediately obvious why a plaintiff should be able to secure the remedy of a constructive trust.

I think that the fourth criterion from *Soulos* should also cause some difficulty for Choice. This criterion requires:

> (4) There must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g., the interests of intervening creditors must be protected.

Soulos was an easy case in relation to this fourth criterion because there were no relevant third parties. In this case the grant of an equitable proprietary remedy stands to benefit the joint

operators, not just as against the secured creditor but also as against unsecured creditors. Justice McDonald does not consider the position of such parties in this case (except to observe that monies paid to third parties in breach of the express trust will not be recoverable by the joint operators on the assumption that such third parties can claim to be equity's darling (a bona fide purchaser for value etc.)). Perhaps the claims of unsecured creditors were moot in this case (e.g. if the secured creditor would be able to seize all remaining assets) but it is possible to imagine scenarios in which the preferred treatment of the joint operator will reduce the monies available to meet the claims of general creditors.

But there is also the question of why we should prefer the interests of the joint operator over the interests of the secured lender. The secured lender, says Justice McDonald, can take steps to protect itself, perhaps by insisting on a covenant to maintain a sufficient reserve in its general account to meet all outstanding trust obligations. But one wonders how effective this would be. If the operator is prepared to ignore the implications of an express trust how seriously will it take a mere negative covenant?

Justice McDonald has nothing to say about the options available to the joint operator. These options include the right to select who is the operator and the right to require that the operator maintain a separate trust account! It seems a little disingenuous for the joint operator to argue that the secured lender is in a better position to protect its interest when it is the adoption of the "have your cake and eat it" commingling provision that arms the operator to commit monies in that commingled account to multiple different purposes.

In conclusion, the 1990 CAPL creates an express trust with respect to surplus AFE monies and production revenues attributable to joint operators. But an express trust does guarantee an effective remedy when the pantry is bare. A constructive trust remedy may be available to fill this gap but it is important to ask, as does the trial judge in this case, whether it is appropriate to grant a joint operator an equitable proprietary remedy. A constructive trust is an exceptional remedy and in deciding whether or not to grant that remedy the Court should take account of the interests of general creditors as well as the interests of any secured creditors. One of the ways to do that is to insist that there be a clear nexus between the breach of trust and the specific property that the plaintiff seeks to attach. A joint operator may also be able to take other steps to protect itself, including careful selection and timely removal of the operator.