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Rights of first refusal in a package sale of oil and gas properties: a follow up to Chase Manhattan

By Nigel Bankes

Cases Considered:

Bearspaw Petroleum Ltd. v. ConocoPhillips Western Canada Partnership, unreported judgement of Master Hanebury, February 26, 2009

Bearspaw Petroleum Ltd. v. ConocoPhillips Western Canada Partnership, 2009 ABQB 202 (Master in Chambers)

The rationale for the right of first refusal (ROFR) in the context of jointly owned oil and gas properties is well understood. ROFRs are typically included in a variety of oil and gas agreements and in particular the operating agreement (see Article 24 of the various iterations of the Canadian Association of Petroleum Landmen ("CAPL") form). But they are messy, especially in so-called package sales where a party is disposing of a number of assets in a particular deal. Current versions of the CAPL form provide a procedure for dealing with package deals but the provisions are not free of difficulty and older forms offer little if any guidance.

There has been some litigation on the ROFR provisions of the CAPL form over the years and one of the leading cases is *Chase Manhattan Bank of Canada v Sunoma Energy Corp.*, 2002 ABCA 286. That case stands for the proposition that in a package deal the vendor is entitled to rely on the purchaser to allocate values within a package deal in order to give effect to a ROFR. However, the Court of Appeal in that case (at para. 25) noted that "the grantor of a ROFR has a duty to exercise its right in such a manner to ensure that the other party's rights are not rendered meaningless" and must do so in good faith. The duty of good faith is owed by the vendor not the purchaser (since there is no privity between the purchaser and the holder of the ROFR rights.)

The ROFR holder has the burden of proof, and to show bad faith it must do more than establish that it, or others, would have assigned a different value to the lands, and more than establish that the purchaser refused "to reveal its methodology or answer questions about the way in which it had valued other lands in the package" (*Chase Manhattan* at para 28). While the Court of Appeal was careful to say that the ROFR holder would not need to evaluate all the lands in the package to prove that the allocated price was not bona fides (at para 30), it is clear that the ROFR holder will face an uphill battle and access to relevant documents may therefore be crucial. And therein lies the significance of the first of these two decisions of Master Judith Hanebury.

The facts

Bearspaw and ConocoPhillips ("CP") owned certain property or properties in common subject to ROFR rights arising from farmout and operating agreements. CP sought to sell certain petroleum and natural gas properties including the ROFR property as part of a package sale. Pengrowth was the successful bidder for approximately $1 billion. The transaction was effected by having CP convey the properties to one of four CP subsidiaries and then having Pengrowth purchase the shares of those subsidiaries. The effective date of the transaction was November 1, 2006 and closing was December 31, 2006.

CP provided notices of disposition of assets to Bearspaw on December 31, 2006 but did not provide a ROFR notice on the grounds that it was a disposition to an affiliate which therefore fell within one of the exceptions typically contained in ROFR clauses including the CAPL agreements.

Bearspaw commenced this action against CP seeking an order setting aside the transfers or assignments or an order requiring CP to provide a ROFR notice. Some months later in March 2008, Pengrowth, "in the interests of certainty", provided Bearspaw with a "business opportunity" in the form of a ROFR notice, but without admitting that Bearspaw was so entitled. The values for the ROFR notice were determined by Pengrowth after the event. Bearspaw filed a notice of motion seeking disclosure of valuation information and Pengrowth cross applied for summary dismissal on the basis that the statement of claim requested a ROFR notice and one had now been provided.

The decisions

There are two separate decisions. The first deals principally with Bearspaw's application for production of documents (*Bearspaw Petroleum Ltd. v. ConocoPhillips Western Canada Partnership*, unreported judgement of Master Hanebury, February 26, 2009); the second with Pengrowth's application for summary dismissal (*Bearspaw Petroleum Ltd. v. ConocoPhillips Western Canada Partnership*, 2009 ABQB 202).

The application for production of documents

Master Hanebury was clearly unhappy with the state of the pleadings before her and noted several examples of the failure of counsel to follow the rules. She granted the application for production of documents in part and dismissed it in part. Master Hanebury dealt with the application under Rule 193 of the *Alberta Rules of Court*, Alta. Reg. 390/1968, noting that this rule sets up a two part test: the record must be referred to in an affidavit and must be in that party's control. Master Hanebury ordered production of: (1) Pengrowth's internal evaluation of the Fenn Big Valley Lands (since this was the starting point for valuing the lands which include the disputed lands); (2) the ROFR notices issued to other working interest owners with respect to the lands in dispute, and (3) a petroleum consultant's report on the Fenn Big Valley Lands.

Master Hanebury rejected Bearspaw's application that the defendants provide the basis on which the purchase price set forth in the ROFR notices had been arrived at on the grounds that that was not a request for documentation.

The application for summary dismissal

As it happens Master Hanebury dealt with this summarily in the first application on the basis that an application for dismissal under Rule 159 of the *Alberta Rules of Court* can only be made after the defendant has filed its statement of defence. Master Hanebury saw no record of that and thereupon summarily dismissed the application. Counsel for Pengrowth subsequently drew Master Hanebury's attention to the defence that had been filed and as a result Master Hanebury considered the matter on the merits; but in the end she still reached the same conclusion.

Master Hanebury noted that in order to succeed on its application for summary dismissal Pengrowth would have to show that the action was bound to fail; and in order to show that, Pengrowth would have to be able to demonstrate (based upon existing case law and in particular *Chase Manhattan Bank of Canada v Sunoma Energy Corp., supra*) that the ROFR notice that it actually provided was a ROFR notice of the type that would have been provided at the time of the original transaction. The evidence adduced before the Court did not establish that and accordingly there was a genuine issue to go to trial.

Comment

It is a little hard to tell from the outside whether this is a serious action. The parties (on the basis of Master Hanebury's comments at para. 19 of the first judgement) seem to be proceeding in a fairly lackadaisical manner. On the other hand, the matter seems significant both in terms of principle and dollars. The dollars speak for themselves. Pengrowth pegged the value of the Fenn Big Valley lands at $145 million (but the relationship between these lands and the ROFR lands is not clear from the judgement).

The significance of the case as a matter of principle relates to two questions: (1) the scope of the vendor's good faith duty to make sure that the ROFR holder's rights are not rendered meaningless, and (2) the question of an appropriate mechanism to make this happen when there is a disconnect between the party owing the duty (the vendor) and the party providing the valuation (especially where the onus of proof - to show bad faith - is cast on the holder of the ROFR rights). One part of this is no doubt working through the information that the holder of the ROFR rights is entitled to receive in order to assess the evaluation.

There are other questions of more substance here that will need to be resolved if the case goes to trial on the merits. These include the question of whether it is ever possible for a vendor to rely upon a purchaser's assessment and attribution of value where that valuation occurs after the fact and is completed and adjusted by the purchaser with a view to keeping the purchaser whole (which in part, for tax reasons may depend upon the manner in which the deal is structured).