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Provincial Court royalty calculation decision

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Cases Considered:

Lyatsky Geoscience Research and Consulting Ltd v. Geocan Energy Inc, 2009 ABPC 392

Very few oil and gas contract matters come before the Provincial Court, principally because of the cap of $25,000 on monetary awards (*Provincial Court Act*, R.S.A. 2000, c. P-31. s.9.6 and *Provincial Court Civil Division Regulation*, Alta. Reg. 329/1989, s.1.1). In this case the plaintiff claimed a gross overriding royalty (GORR) and sought to recover from the defendant the difference between a 3% royalty paid on 7.5% of production from a property and 3% royalty paid on 100% of production. According to the plaintiff, the difference amounted to some $17,000 between 2006 and November 2008. Presumably, the plaintiff would also use any judgement from the Provincial Court in their favour to argue (absent the right to obtain a declaration from that Court) that future payments should also be based upon the terms of the judgement. The case was complicated by the fact that there was no direct privity between the parties. Judge J.T. McCarthy ruled in favour of the plaintiffs.

The facts

Lloyd granted Lyatsky a 3% gross overriding royalty in various working interests owned by Lloyd and in the following terms:

> Grantor hereby grants and sets over to Grantee a 3% GORR on 100% of production to be paid from Grantor's working interest in the lands as set forth in schedule A hereto (at para. 3).

At the time, Lloyd had a 7.5% working interest (WI) in the relevant lands. Lloyd and the other WI owners farmed out their interest in the relevant lands to Westerra. Westerra became a wholly owned subsidiary of Geocan (the defendant). The Lyatsky GORR was identified in the farmout as a permitted encumbrance where it was described as a 3% GORR "payable on the pre-farmout interest of Lloyd Venture 1 Inc" (at para. 4). Westerra drilled the test well and earned its interest. Westerra's first payment to Lyatsky was calculated on the basis of a 3% royalty on 7.5% of production. Lloyd complained on behalf of Lyatsky and, Westerra, having previously obtained a copy of the GORR agreement, commenced paying the 3% royalty on 100% of production. This

practice continued over a two year period until Westerra became a subsidiary of Geocan at which time royalty was paid on 7.5% of production.

Lyatsky sued for the difference between a royalty calculated on 7.5% and royalty calculated on the basis of 100% of production. Geocan defended on the basis that: (1) the royalty was not an interest in land and that Geocan was not bound by it, and that (2) if it were, the royalty was only payable on 7.5% of production.

The judgement

Judge McCarthy ruled in favour of Lyatsky on both grounds. First, Judge McCarthy held that the royalty was an interest in land and, as such, bound Geocan. The Court does not offer any reasons for this conclusion or any supporting case law. There is simply the bald assertion (at para. 11) that the Lyatsky GORR "made [it] clear that the royalty was to be an interest in land". Presumably the agreement must have contained a statement to that effect (i.e. "the parties intend that this GORR is an interest in land") and if it did (and on the further assumption that the interest out of which the GORR was carved was itself an interest in land - a matter on which there is no discussion) that would be enough to satisfy the Supreme Court of Canada's decision in *Bank of Montreal v. Dynex Petroleum Ltd*., [2002] 1 S.C.R. 146 (not mentioned in Judge McCarthy's decision). Judge McCarthy's conclusion on this point should have been enough to deal with the absence of privity between the plaintiff and the defendant since those acquiring Lloyd's interest clearly had notice of the GORR.

However, Judge McCarthy then went on to deal with what must have been an alternative argument based on novation. The going gets a bit tough here since the reader really needs to know a few more facts than the judgement provides, but it appears that while in some cases there were assignments there was clearly no novation agreement (if there were a novation (and indeed a series of novations were likely required) why does Lyatsky get Lloyd to make inquiries on its behalf? And why would Lloyd accede to such a request if it had dropped out of the picture?). Ultimately, Judge McCarthy reaches the rather suspicious conclusion that there was a novation by course of conduct or implied novation. I say "suspicious" because the main authorities (*National Trust Company v Mead*, [1990] 5 W.W.R. 459 (SCC) and *Canada Southern Petroleum v. Amoco Canada Petroleum Co.*, 2001 ABQB 803, neither of which are cited) suggest that it is very difficult to establish a novation by course of conduct. And in this case is there any suggestion that Lyatsky had released Lloyd from the duty to pay the royalty based on the original contract? No, to the extent revealed in the judgement, the course of conduct suggests otherwise.

In any event, either route takes us to the second question which was the point of construction. Was this royalty payable on 7.5% of production or on 100% of production? It is of course possible that a person in Lloyd's position will agree to pay a royalty on 100% of an interest even though Lloyd only owns a fraction of that interest or none of that interest. C can agree to pay B 10% of what the house across the road sells for even though C has no interest in that house. But one would think that an unusual arrangement and therefore one might require clear words to reach that counter intuitive conclusion. One might also think that while one can do this as a

matter of contract it does seem like a very strange interest in land where the royalty is carved out of the particular undivided working interest but somehow is calculated by reference to the whole.

Nevertheless, unusual as it might be, Judge McCarthy found for Lyatsky on this issue as well. Judge McCarthy seems to have been persuaded by two things. First, the language of the agreement: i.e. a GORR "on 100% of production" but "to be paid from Grantor's working interest in the lands". And second, and to the extent that the agreement might be ambiguous, resort could be had to the practice of the parties to resolve the ambiguity (at para. 12); and here, the "correction" made by Westerra suggested that the parties believed that the royalty was payable on 100% of production.