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The interaction of the offset well and default clauses of an oil and gas lease

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Case commented on:

1301905 Alberta Ltd. v Sword Energy Inc. 2013 ABQB 113

In this case the Court granted summary judgement for breach of the offset well obligation in an oil and gas lease. Assessment of damages was referred to a referee.

The Facts

Sword was the assignee of a petroleum and natural gas lease of the south half of section 15. The lease was in the 1991 CAPL form (information provided by counsel) and 1301905 Alberta Ltd. was the assignee of the lessor's interest. Sword drilled a producing well on the lands in 2007. In January 2010, 1301905 Alberta Ltd. served a default notice on Sword alleging that Sword was in breach of the Offset Wells clause of the lease and claiming compensatory royalties based on production from the offsetting well.

The offset well clause provided that if certain conditions were fulfilled, the lessee shall, within six months of commercial production being obtained from offsetting acreage, do one of four things: (a) commence or cause to be commenced operations for the drilling of a well, (b) pool or unitize the leased lands with the producing lands, (c) surrender the leased lands or the relevant zone, or (d) pay a compensatory royalty (the "compound obligation').

The default clause provided that:

> (a) If, before or after the expiry of the primary term, the Lessor considers that the Lessee has not complied with any provision or obligation of this Lease … the Lessor shall notify the Lessee in writing, describing in reasonable detail the alleged breach or breaches. The Lessee shall have 30 days after receipt of such notice to:
> i) remedy or commence to remedy the breach or breaches alleged by the Lessor, and thereafter diligently continue to remedy the same; or
> ii) commence and diligently pursue proceedings for a judicial determination as to whether the alleged acts or ommisions [sic] constitute a breach or breaches on the part of the Lessee.

Sword did not pay the requested compensatory royalties or commence the proceedings contemplated by the default clause although it did, by letter of February 24, 2010, take the position that there was no breach of the offset well clause since no drainage was occurring.

Subsequently, on June 22, 2011 Sword, by written notice (at para 11), "terminated the Lease and surrendered the offset zones in the Well."

On the basis of these facts 1301905 Alberta Ltd. sought summary judgement.

The decision

Justice Donald Lee granted the application for summary judgement. Drawing an analogy with limitations law he concluded that when Sword failed to commence an action within 30 days to ascertain whether the alleged acts or omissions constituted a breach of the lease, Sword lost its right to defend its position on that alleged breach. Accordingly, 1301905 Alberta Ltd.. was entitled to damages for breach of the lease (at para 43) "including Cl.15(c)," such damages to be assessed by a referee pursuant to Rule 7.3(3) (b) of the Alberta Rules of Court.

Commentary

At least, I think that the above is what Justice Lee decided, but it would be nice to know a lot more about the apparently simple facts before being more definitive. I say this because some things remain puzzles. For example, at paragraph 6 we learn that Sword spudded in a well (the Well) on the leased lands in 2007 and obtained commercial production. We never learn if this Well is still producing (and if so from what formation(s)), or, if not, when it ceased to produce. It would be nice to know this because if the Well is still producing it has some implications for the remedy available to the lessor under the default clause (no termination of the lease if there is a well capable of production on the lands) and it would help us make sense of just what Sword did on June 22, 2011 when it (at para 11) "terminated the Lease and surrendered the offset zones in the Well" (termination *and* surrender? the entire lease or just the relevant zones?)).

Two paragraphs later we learn that 1301905 Alberta Ltd.'s alleged breach of the offset clause "based on the commercial production from the spudded Well." That's right, that's "breach" of a default clause and an upper case "Well." What seems like a momentary lapse however is compounded later in the judgement with the following two paragraphs:

> [32] First, on the basis of the record before me, the fact is clear and undisputed that Sword drilled Offset Wells (*sic*) on the Lessor's Lands. And further, the Applicant in its Affidavit of Records provided production records from Alberta Energy Resources Conservation Board (ERCB) which confirmed commercial production from the Offset Wells on the Lessor's Lands.
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> [33] Secondly, I do not agree that the determination of the legal issue as to whether the Offset Wells Clause has been breached based on the breach of the Default Clause in the Lease would require an extensive weighing of additional evidence in a full trial outside the facts that are already known in this application.

So where were the offsetting well(s) drilled? On the Lessor's Lands? I thought that an offsetting well was a well drilled on offsetting acreage. And if they were offsetting well(s) how does production from an offsetting well establish production on the leased lands (and why was that relevant anyway)? Or perhaps Justice Lee is making a distinction between the leased lands and the lessor's other lands (perhaps the lessor owns the offsetting acreage?) In any event, I hope I have said enough that you get the point, some of this seems about as clear as mud.

I have two more substantive points to make. The first relates to the numerous instances in which Justice Lee concludes that Sword is in breach of the default clause (see paras 21, 26, 27, 28, 33, 35, and 44). It seems odd to me to talk the "breach" of a default clause. It is true that the clause uses the mandatory "shall" but properly construed all that the clause does is to provide the lessee with two options in the event of a claimed breach: (1) take steps to remedy the breach, or (2) commence proceedings. The failure to elect either option is not a breach of an obligation, it simply exposes the lessee to termination of its lease:

> … this lease … shall thereupon terminate and it shall be lawful for the Lessor to re-enter the said lands and to repossess them.

The breach of the lease at issue here is not the breach of the default clause it is the breach of the compound obligation represented by the offset well clause. That compound obligation stipulates that where an offsetting well obtains commercial production then the lessee within six months must do one of four things, all as stipulated in the lease and described above. One of these four things is the payment of a compensatory royalty. The lessor does not get to decide which of these actions the lessee is to take although the lessor is entitled to insist that the lessee do one of these four things. And the lessor is entitled to take the position that if the lessee fails to do any of the four things then the lessor can serve the default notice in proper form. The proper form requires that the lessor describe in reasonable detail the alleged breach or breaches.

The claim that it is incorrect to talk about the breach of a default clause may be just pedantry on my part but it may also have some bearing on Justice Lee's characterization of the consequences of the "breach" of the default clause – or as I would put, the lessee's failure to exercise one of its two options. The usual consequence would presumably be termination (either by the exercise of the right of re-entry or by way of a judicial declaration) but funnily enough nobody seems to be arguing about termination here, the argument is simply about damages. So what of the consequences of "breach" in this case? Well, apparently, the consequence of breach of the default clause is that Sword has somehow lost its opportunity to contest that it was in breach of the offset well clause and this means that 1301905 Alberta Ltd. is entitled to summary judgement (at paras 27 – 28) on liability leaving only the question of damages to be referred to a referee.

Now this seems quite draconian to me. It is one thing to say that the lessee has lost the right to object to termination. After all, one way to think about the "notice and options" provisions of the default clause is that these provisions are simply establishing the pre-conditions to lawful termination. The lessor has complied with them and accordingly can now terminate the lease (subject of course to the potential availability of relief from forfeiture, since apparently we are not talking about automatic termination for want of production) by way of judicial declaration or re-entry. But the lessor does not need the default clause to sue for breach of the offset well clause. Breach of the offset well clause may give grounds for termination; but termination and\or notice of default are not a precondition for bringing suit for breach of the offset well clause and a consequential claim for damages. And if this is correct is it still clear that this was an appropriate case for summary judgement?

Well, perhaps, but maybe not for the reasons given by Justice Lee. It may be the case that the lessor deserves summary judgement because the only defence that 1301905 Alberta Ltd. has (or the only defence we hear about) to a breach of the compound obligation of the offset well clause is not a good defence. That defence seems to be Sword's claim that there is no drainage from under 1301905 Alberta Ltd.'s lands. But that is no defence to the breach of the compound obligation of the default clause. Actual drainage or proof of drainage is not a trigger to the

lessor's claim and proof of absence of drainage is not a good defence – and it may not even be relevant to the assessment of damages if those damages are claimed simply on the basis of compensatory royalty as provided for under clause 8(d).