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When does the purchaser of an interest in a natural gas processing plant also purchase an interest in the sulphur block associated with the plant? Answer: only when the agreement (or perhaps 'the elephant in the room') says so!

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Case commented on:

Talisman Energy Inc v Esprit Exploration Ltd, 2013 ABQB 132

Talisman purchased Canadian 88's interest in the East Crossfield Conditioning Plant in 2000. Did it also purchase the sulphur block and the liabilities associated with ownership of the block? In this case, and after undertaking an extensive and detailed contractual paper trail, Justice Sal LoVecchio concluded that the answer was no. The 'elephant in the room' was C88's draft purchase and sale agreement (PSA) (which Talisman elected not to use) which, had it been executed, would have dictated the opposite result.

The Facts

In 2000 Canadian 88 ((C88) subsequently Esprit and Pennwest) disposed of its interest in the East Crossfield Conditioning Plant to Talisman. In 2007 Talisman commenced an action against Esprit and against Primewest (subsequently TAQA) as operator of the Plant seeking a declaration that it did not acquire an interest in the sulphur block associated with the plant when it acquired an interest in the Plant. In 2010 TAQA commenced a second action against Talisman and Pennwest seeking recovery against one or other.

In selling its properties (part of a larger agenda of seeking to dispose of non-core assets) C88 retained Waterous to assist it in marketing its properties and made use of an Initial Memorandum (IM) describing the properties and a confidential data room. The IM described C88's interest in two unit agreements (East Crossfield (D-1) and Elkton) and in the agreement to construct own and operate (COO) the Plant (or more specifically the D-1 and Elkton units of the Plant). Talisman was ultimately novated into the COO. The COO distinguished between ownership of the Plant and ownership of Plant Products (which included sulphur). Plant Products were owned in accordance with the tract participation factor in the D-1 unit (as that varied from time to time). Ownership interests in the Plant did not correspond with ownership interest in the sulphur block (at paras 39 and 40). Some non-owners (in the Plant) had an ownership interest in the sulphur block. The original COO did not have a lot to say about the sulphur block but the parties interested (Plant owners and non-owners) ultimately developed a Solid Sulphur Storage Procedure (SSSP). Sulphur tracking records were provided from time to time but not consistently and there was evidence that no tracking records were found in the files Talisman received from C88 (at para 59).

Under the PSA (and as noted above Talisman elected to start with its own version of a PSA rather than the version proffered by C88 in the Data Book (at para 19)), Talisman agreed to purchase "Assets" defined as "the Petroleum and Natural Gas Rights, the Miscellaneous Interests and the Tangibles...."

The term "Tangibles" was defined to include the Facilities Interest which in turn referred to a list of Facilities in a Schedule which included the "4.81915% interest of Canadian 88 in the East Crossfield Gas Conditioning Plant." The term also included "tangible depreciable property and assets" which are assets "situate in, on or about the Lands…and which are used in connection with production, gathering, processing, injection, removing, transmission or treatment of Petroleum Substances…but excluding equipment beyond the point of entry into a gathering system, plant or other facility."

The PSA defined "Miscellaneous Interests" (at para 104) as "… the right, title, estate and interest of the Vendor in and to all property, assets and rights (other than Petroleum and Natural Gas Rights and the Tangibles) pertaining to, but only to the extent they pertain to, the Petroleum and Natural Gas [PNG] Rights, the Tangibles or any lands with which the Lands have been pooled or unitized, including without limitation, the interest of the Vendor in the following… ."

The judgement

Justice Sal LoVecchio concluded that Talisman did not acquire an interest in the sulphur block under the terms of the PSA and neither was Talisman liable to pay some or all of the costs associated with the sulphur block by virtue of either the general indemnity clause of the PSA or by virtue of being novated into the COO Agreement.

C88's interest in the sulphur block was not included within the Tangibles branch of the definition of Assets for a whole slew of reasons. Talisman purchased C88's interest in the Plant and the sulphur facility under the heading of "Facilities" but the definition of Facilities did not extend to the sulphur block itself. Neither was the sulphur block tangible depreciable property. The block did not decrease in value as it was used (unlike machinery or equipment) and it was not situated "in, on or about the Lands" (at para 96) since the Lands that were referred to were the petroleum and natural gas properties. The sulphur block was also "beyond the point of entry into a gathering system" (at para 97). Nor could it be contended that the sulphur block was used as a consumable commodity within the operations of the plant (at para 99).

Neither was C88's interest in the sulphur block included within the "Miscellaneous Interests" branch of the definition of Assets since the sulphur block did not pertain to the PNG rights since the production operations did not in any sense depend upon the sulphur block (at para 111):

> No part of the operations relies on the Disputed Interest in the sense that the conditioning process requires the use of sulphur as a fuel, feedstock or otherwise. Sulphur emerges as a byproduct of conditioning and is either sold at that time or stored pending further direction from its owner and as a result there is no such reliance or necessity.

Neither did Talisman assume responsibility for the sulphur block under the general indemnity and environmental indemnity provisions of the PSA. The indemnities relate to the Assets; since the sulphur block was not an Asset it was not subject to the indemnity (at para 120). Nor was the novation of Talisman into the COO in itself enough to require Talisman to assume responsibility

for the costs associated with the storage of an asset retained by the vendor. Talisman's novation into the COO merely recognized that it had already acquired an interest in the Plant and the Sulphur Facilities but not the sulphur block (at paras 120 – 150).

Neither did the overall conclusion change when the Court took account of the background to Talisman's acquisition of the property and in particular the draft PSA included in the Data Book that was made available to interested parties (at paras 152 – 175). The draft PSA (had it been used – it was not, as noted above, Talisman offered its own form of the PSA) would have made it clear that sulphur stored on site would have been included in the definition of Miscellaneous Interests. However, other elements of the factual matrix pointed in the other direction and on the whole supported the conclusion already reached.

A limitations argument by Primewest (at paras 177 – 185) and a misrepresentation argument by Talisman (at paras 185 – 189) were both dismissed summarily as disingenuous.

Commentary

This is a long and complicated decision which carefully works through the necessarily complex contractual chain before coming to well reasoned conclusions. Are there broader lessons to be learned from the decision? This is not immediately clear but I am sure that the decision will lead counsel to scrutinize (once again) the crucial definition of Assets (and its main component elements) in any and all purchase and sale agreements and Justice LoVecchio's observations on the language of these particular definitions will undoubtedly prove useful as will his general observations on contractual interpretation although (as Justice LoVecchio acknowledges) his judgement draws heavily on Justice Poelman's judgement in *Nexxtep Resources v Talisman Energy Inc*, 2012 ABQB 62, aff'd 2013 ABCA 40 (and for my post on that decision see here).

But at the end of the day it is perhaps Justice LoVecchio's response to what he calls the "elephant in the room" that might attract most discussion. The "elephant in the room" was the draft PSA that C88 had included in the Data Book that had been made available to interested parties. C88 encouraged the use of the draft PSA but it was not essential and evidently Talisman preferred to use its own version of the form. But the point is this, had Talisman used that form Justice LoVecchio was fairly clear in concluding that judgement would have gone the other way:

> [157] In the draft Purchase and Sale Agreement contained in the Data Book, "Miscellaneous Interests" is a defined term. Just as in the PSA it enumerates a number of items and as one might expect they are to a large extent similar to those which appear in the PSA. There is one very significant difference.
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> [158] The Miscellaneous Interests definition in the draft is Article 1.01 - i). Sub (iv) of this definition reads "all Petroleum Substances produced beyond the wellhead but not sold and in storage or tanks at the Effective Date". Petroleum Substances is also defined. The definition is found in Article 1.01 - m) and sulphur is a specifically enumerated Petroleum Substance.
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> [159] Had the words in Article 1.01 - i) (iv) of the draft PSA made their way into the PSA, there is little doubt in my mind that Talisman would now be the proud owner of the Disputed Interests.

Which of course leads to the obvious question: is a draft agreement proffered by one of the parties as the basis for negotiations admissible evidence as to the intentions of the parties as to the meaning to be attributed to the final written agreement between them, especially where, as here, Justice LoVecchio had found no ambiguity (at para 154) in the chain of documentation. I should have thought before reading this judgement that the answer should be an unequivocal "no" for the reasons nicely summarized in Justice Poelman's judgement in *Nexxtep* and drawing upon earlier judgements of the Alberta Court of Appeal (*Gainers Inc v Pocklington Holdings Inc* 2000 ABCA 151 and the House of Lords (*Prenn v Simmonds*, [1981] 3 All ER 237 (HL) per Lord Wilberforce):

> The authorities, hold, however, that evidence of the factual matrix should not include the parties' negotiations. Lord Wilberforce explained that evidence of prior negotiations is not admitted because it is not helpful, rather than for technical reasons or efficiency. Where negotiations are difficult, positions change until the parties achieve consensus. Evidence of the use of different expressions or the same expressions does not usually help interpretation of the contract's words, and may occur in a context of different surrounding circumstances.

But notwithstanding this weighty authority Justice LoVecchio does seem to have concluded that in this case evidence as to the content of the draft PSA was admissible (at paras. 174 – 175).

But even if admissible as evidence as to the intentions of the parties as to the meaning of the final document, the draft PSA alone could be far from conclusive since other admissible evidence tended to support the conclusion that C88 well knew how to include the sulphur assets in a transaction but failed to do so.

All of this allowed Justice LoVecchio to conclude that: (1) absent evidence of the draft PSA Talisman did not purchase the sulphur assets, and (2) even taking into account evidence of the draft PSA, that evidence, when considered with other admissible evidence as to the matrix of negotiations, did not change the result that had already been reached (at para 175). Perhaps all that Justice LoVecchio was trying to do here was to protect the parties from the cost and expense of a new trial in the event that he had ruled that the evidence was inadmissible and had the Court of Appeal chosen to disagree with that conclusion (on that possibility see here the recent judgement of the Court of Appeal in *AG Clark Holdings Ltd v HOOPP Realty Inc*., 2013 ABCA 101 at paragraphs 26 -27 taking into account the drafting and negotiation history of an agreement, but note that the premise as to admissibility in that decision does seem to be assumed ambiguity – not so here). While this is a laudable objective, Justice LoVecchio might have chosen a slightly different route to achieve the chosen result. As it stands his judgement seems to suggest that he thought that evidence as to the content of the draft PSA was admissible notwithstanding his conclusion that the final agreement was not ambiguous. The idea that one party's version of an agreement which was never taken seriously by the other side should be admitted as evidence of the intentions of the parties as to the interpretation of the final written agreement between the parties is a long stretch, and one that if broadly adopted will increase the prospects of litigation and the length of trials.