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What happens when A sells B a working interest in the thermal or enhanced production from an oil and gas property and A or its successors in interest continue with primary production?

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What happens when A sells B a working interest in the thermal or enhanced production from an oil and gas property and A or its successors in interest continue with primary production? This was the issue at the heart of this decision. The answer is that B gets shafted; B should have taken better steps to protect itself rather than simply assuming that all future production from the property would take the form of enhanced or thermal production.
In the course of his lengthy 73 page judgement Chief Justice Neil Wittmann (acting in place of Justice Ron Stevens (deceased)) addressed a number of questions of oil and gas law which will be of interest to the energy bar including the following: (1) What property interest did IFP acquire? (2) What is the test for determining whether a working interest owner has reasonable grounds for refusing consent to an assignment of shared interest lands under the 1990 CAPL Operating Procedure? (3) What is the legal position where a working interest purports to withhold consent and the Court subsequently determines that the withholding of consent was unreasonable? (4) Did the development of the property through primary production techniques substantially nullify the benefit for which IFP (B) had bargained so as to amount to a breach of contract? (5) Assuming that there was a breach of contract how should damages be assessed? (6) Assuming liability should any claim for damages be capped by a contractual agreement between the parties?

The facts and the agreements between the parties

IFP (a wholly owned subsidiary of IFP Energies Nouvelles of France) had expertise and technical information in relation to the drilling, placement and completion of horizontal wells. Beginning in the late 1980s IFP entered into a series of agreements with CS Resources, a pioneer in the use of horizontal wells for the development of heavy oil resources. As part of the first series of these agreements CS Resources granted IFP a 3% gross overriding royalty (GOR) on all CS lands on which IFP's technology was applied. PanCanadian (PCR) acquired CS Resources in 1997. IFP and PCR eventually concluded that the GOR model was inappropriate and agreed to replace it with a working interest model. That agreement was recorded in an MOU of July 1998 and an Asset Exchange Agreement (AEA) of October 1998 to which were scheduled a joint operating agreement (JOA) and its appended operating procedure, which was an amended

version of the CAPL 1990 Operating Procedure. This second set of agreements covered both the original CS Resources lands as well as other lands rolled in to the deal by PCR including properties referred to as the Eyehill Creek Assets. At the time of the AEA there were already 222 conventional wells on these lands.

Under the AEA IFP was to acquire a 20% working interest in the PCR lands including the Eyehill Creek Assets. The granting language of the AEA provided as follows (at para 67):

> PCR hereby agrees to sell, assign, transfer, convey and set over to IFP, **and IFP hereby agrees to purchase from PCR, all of the right, title, estate and interest of PCR** (whether absolute or contingent, legal or beneficial) **in and to the PCR assets, … all subject to an in accordance with the terms of this Agreement**. (emphasis is CJ Wittmann's)

The idea that IFP's interests were actually limited to thermal and enhanced production first seems to have been introduced in the terms of the JOA which was scheduled to the AEA. Clause 4(c) provided (at para 92):

> 4(c) It is specifically agreed and understood by the parties **that the working interests of the parties as described in Clause 5 of this Agreement relate exclusively to thermal or other enhanced recovery schemes and projects** which may be applicable in respect of the petroleum substances found within or under the Joint Lands and the Title Documents. Unless specifically agreed to in writing, **IFP will have no interest and will bear no cost and will derive no benefit from the recovery of petroleum substances by primary recovery methods from any of the rights otherwise described as part of the Joint Lands or the Title Documents.** (emphasis is CJ Wittmann's)

Other provisions of the JOA, including the definition of working interest and the nature of the parties' participating interests, all simply referred to the interests of the respective parties in the lands without further qualification by reference to the nature of the production process.

Under the attached CAPL operating procedure the parties had elected the right of first refusal option (ROFR) under Article 24 (at para 110) and the agreement seems to have contained the standard provisions on independent operations (with some amendments) with a 400% penalty (at para 107). Another element of the JOA was a series of clauses that relieved IFP of any responsibility for the abandonment of the conventional (primary production) wells on the Eyehill Creek property (at para 33).

By the late 1990s PCR was concerned about its ability to hold on to the Eyehill Creek lands and was focusing on developing other assets such as its Christina Lake property. One of PCR's Eyehill leases had expired and in other cases Alberta Energy had issued notices on continued leases requiring PCR to establish the productivity of the properties. Oil prices were depressed and PCR had shelved any idea of introducing a thermal recovery operation at Eyehill. Given these concerns and concerns as to the abandonment liabilities associated with its existing wells, PCR was receptive to proposals to removing itself from the property. In 2001 PCR executed a letter agreement with Wiser which was a form of farmout agreement (ultimately formalized as an Abandonment, Reclamation and Option Agreement (ARO)) pursuant to which Wiser would earn PCR's working interest in the Eyehill Creek lands by "dealing with" the existing 222 wells by

abandonment and reclamation, by re-working them or by putting them on production. It was clear that Wiser was only interested in the primary production possibilities from these lands.

PCR gave IFP the ROFR notice to which it was entitled in April 2001. At about the same time Wiser also sought (unsuccessfully) to clarify with IFP that IFP's working interest was confined to enhanced and thermal recovery operations. IFP declined to exercise its ROFR but did withhold consent to the disposition on the grounds that Wiser "had no technical capability or intent to pursue thermal or other enhanced recovery" (at para 52; see also para 167). PCR proceeded to execute the ARO. Wiser protected itself through an indemnity agreement with PCR. Wiser was never novated into the AEA and related agreements. Wiser commenced the operations contemplated by the ARO and earned its interest. Wiser never informed or consulted IFP as to the nature of those operations. Canadian Forest acquired Wiser's interests in 2004. All of the operations conducted by Wiser and Canadian Forest were primary production operations; none involved enhanced or thermal recovery.

On the basis of these facts IFP alleged that the Wiser farmout (the ARO) was a breach of contract and sought damages. PCP took the view that IFP had unreasonably withheld its consent to the proposed agreement.

What property interest did IFP acquire?

I think that there are two possible interpretations of what IFP acquired. One interpretation (which I will refer to as the property-limited-by-contract interpretation) is that IFP acquired an undivided interest as a tenant in common of the relevant Crown leases and other assets (subject to some *contractual* limitations on its precise rights in relation to those assets). A second interpretation (which I will refer to as the property interpretation) would hold that IFP acquired something in the nature of a working interest in production from the lands resulting from thermal or other enhanced recovery techniques. There are pros and cons to each of these interpretations. The principal argument in favour of the property-limited-by-contract interpretation is that that it is the natural interpretation of the granting words used in the dominant agreement, the AEA. It also has the advantage that it accords IFP a legally coherent and cognizable interest in the property. We know what the basic rights of a tenant in common are. The contrary argument is that this classification does not seem to be consistent with the overall intentions of the parties which suggested that IFP's rights prima facie did not extend to primary production. But the best way to respect that intention is to conclude that the property rights of IFO as a tenant in common were limited by the terms of the other contractual arrangements between them, including the key provision in the JOA referred to above.

The principal argument in favour of the property interpretation is that it delivers a result that seems to comport with the overall result intended by the parties reading all of the agreements together and the commercial context for those agreements. The principal knock against this interpretation is that it fails to respect the dominant conveyancing language of the AEA and as a result delivers an interest which is unrecognizable in terms of property law. It is one thing to have an undivided interest which is confined to a particular formation or formations; or to have an undivided interest in a particular substance; but we create a whole new layer of complexity when we admit of the possibility that ownership of an interest in land varies with the nature of production from those lands. Not only is this complex but it seems to be inconsistent with the royalty-as-interest-in-land cases culminating in *Bank of Montreal v Dynex Petroleum Ltd*, 2002 SCC 7. If an interest in the proceeds of production cannot give an interest in land how can a

party have a tenancy in common (not just any old interest in land, but an undivided interest) in a Crown lease that is contingent on the mode of production of the leased substances?

How was this issue resolved here? Chief Justice Wittmann seems to suggest that both the plaintiff and the defendant adopted some version of the property-limited-by-contract approach but the Chief Justice himself preferred some version of the property approach (at para 97):

> I find that IFP's working interest pursuant to these agreements has always been limited to thermal and other enhanced recovery methods. I find the AEA did not grant broad rights that were subsequently reduced or modified by the JOA, as assumed by both the Plaintiff and the Defendants. The AEA does not define the term working interest. The Preamble to the AEA states, however, that the ownership of working interests is subject to and in accordance with the terms and conditions of the JOA. Furthermore, the JOA is incorporated by reference into the AEA as though it were contained in the body of the AEA. As such, the definition of working interest in the JOA is incorporated by reference into the AEA.

See also para 194 where the Chief Justice comments further on the relationship that the parties have created.

But whatever interpretation is adopted it is still necessary to work through the applicability of the operating procedure to primary production. We don't have the complete story from the judgement and in particular we do not know the full extent to which the parties modified the CAPL 1990 form, but one would anticipate that significant changes would be required to make it work in these circumstances. Consider, however, what we do know. We know (see para 54) that Wiser carried out operations on the lands once it had acquired its interest in the property and we know that it did not inform IFP about those operations. We can infer from this that Wiser was not in the habit of sending IFP AFE (authorizations for expenditure) notices (which passes without comment in the judgement). Yet on the other hand the Court and the parties assume the applicability of the independent operations clause (modified as discussed at paras 105-107) with the result that Chief Justice Wittmann concludes that IFP might have been able to trigger the clause – although as a matter of practice it lacked both the capital and the operational expertise to be able to do so (at para 197). But even aside from this practical problem facing IFP, it would be extremely difficult legally for IFP to propose an effective independent operation where there were already licensed wells for the relevant drilling spacing units.

The complexities of determining the applicability of various clauses of the CAPL procedure (absent an express statement as to (in)applicability) seem legion. What about the applicability of the CAPL provisions dealing with access to information? Was IFP entitled to information about primary production from the lands (referred to at para 176)? What about Article XI dealing with the surrender of joint lands (referred to at para 221)?

The difficulties were also evident with respect to Article 24, the ROFR/consent provision of the procedure. Given Chief Justice Wittmann's conclusions as to just what it was that IFP had obtained (i.e. a working interest in only thermal and enhanced production) there was a certain logic to PCR's position (at para 140) that the transfer to Wiser should not trigger Article 24 since Wiser was only interested in primary production. The difficulty with that argument however was that whatever Wiser's intentions with respect to what it would produce (and how), Wiser was clearly acquiring PCR's entire interest in the property. Thus Chief Justice Wittmann is surely correct in concluding (at paras 141-145) that the Wiser transaction did trigger Article 24. The

question would have been more difficult had PCP retained its rights to thermal and enhanced production.

What is the test for determining whether a working interest owner has reasonable grounds for refusing consent to an assignment of shared interest lands under the 1990 CAPL Operating Procedure?

The ROFR provision of the 1990 CAPL afford each working interest owner (WIO) two independent rights: the ROFR right itself and the right to refuse consent to the proposed transfer even where the WIO will not exercise the ROFR.

> 2401B(e) In the event that the working interest described in the disposition notice is not disposed of to one or more of the offerees pursuant to the preceding Subclause, **the disposition to the proposed assignee shall be subject to the consent of the offerees. Such consent shall not be unreasonably withheld, and it shall be reasonable for an offeree to withhold its consent to the disposition if it reasonably believes that the disposition would be likely to have a material adverse effect on it, its working interest or operations to be conducted** hereunder, including, without limiting the generality of all or any part of the foregoing, a reasonable belief that the proposed assignee does not have the financial capability to meet prospective obligations arising out of this Operating Procedure. … (emphasis is CJ Wittmann's)

This gives rise to two questions. The first is really a methodological question – how should the Court go about analyzing such a question. And the second is that of how to apply the preferred approach to the facts at hand. As for the methodology, both counsel and the Court (at para 152) decided to rely on case law dealing with the unreasonable withholding of consent in the context of the landlord and tenant relationship. There might be some doubts as to the applicability of this body of law in this setting and thus it is useful to have the Court affirm its relevance. From this body of law the Chief Justice derived the following principles (at paras 153-158):

> [153] The burden of proof is on the party asserting consent was unreasonably withheld: *Sundance Investment Corporation Ltd v Richfield Properties Limited* (1983), 41 AR 231 at para. 23 (CA).
> [154] The party whose consent is required is entitled to base its decision on its own interests alone: *Community Drug Marts P & S Inc, Estate of v William Schwartz, Construction Co Ltd,* 31 AR 466 at para 41, (QB), aff'd [1981] AJ No 537.
> [155] Whether a person has acted reasonably in withholding consent depends on all the factual circumstances: *Exxonmobil Canada Energy v Novagas Canada Ltd,* 2002 ABQB 455 at para 49. The question is not whether a reasonable person might have given consent, but whether a reasonable person could have withheld consent in the circumstances: *1455202 Ontario Inc v Welbow Holdings Ltd,* [2003] OJ No 1785 at para 9 (ONSC) ("*Welbow*"). In *Exxonmobil*, Park J reviewed the evidence on an objective basis to determine whether in the circumstances a reasonable person would have refused to consent to the assignment.
> [156] A party must not refuse consent where such refusal is calculated to achieve a collateral purpose, or benefit, not contemplated by the original contract: *Welbow* at para 9.

> [157] Proceeding with an assignment in the face of a reasonable refusal to consent is a clear breach of a negative covenant: *Exxonmobil* at para 51.
> [158] The court should not defer to the party withholding consent, but must assess the reasons for withholding consent and consider whether a reasonable person in similar circumstances would have made the same decision. The court should consider the purpose of the consent clause and the meaning and benefit it was intended to confer.

Notably absent from this list is any reference to the venerable decision of the English Court of Appeal in *Houlder Brothers v Gibbs*, [1925] 1 Ch 575, which stands for the proposition that a lessor will be able to withhold consent on grounds related to the personality of the proposed assignee or the use and occupation that the proposed assignee will make of the leased premises. Admittedly it is very difficult to reconcile *Houlder Brothers* with the majority decision of Alberta's Court of Appeal in *Sundance*, but recall that in *Sundance* the majority was clearly of the view that a lessor had good grounds to object to any assignment that prejudiced the lessor's financial interest. I have never been very persuaded by that approach and much prefer Justice Harradance's dissenting judgement but in this case both *Houlder* and the majority judgement in *Sundance* seemed to offer some comfort to IFP.

Indeed, if one looks simply to the outcome of the transfer in this case it look like a case in which IFP should be able to withhold consent. After all, if IFP failed to forestall the transfer it was going to be forced into a joint venture with a party that had the announced interest of exploiting the property exclusively for its primary production potential. Not only would that exclude IFP from the opportunity to take its 20% share of production, it would also prejudice the economics and perhaps physical feasibility of future enhanced or thermal recovery operations at the site. But for Chief Justice Wittmann this was an oversimplification. He concluded that IFP's withholding of consent was unreasonable.

Ultimately I think that the principal reason for this conclusion is that as a matter of law IFP is no worse off after the Wiser transaction than it was before the transaction. This is because PCR was under no legal obligation to develop the thermal and enhanced recovery potential of the lands. IFP had failed to contract for that obligation. One may question how consistent this is with the landlord and tenant cases which I think clearly allow the landlord to use the right to withhold consent as a means of ensuring that the property is not used for certain purposes even though the landlord had not specifically contracted against those uses in the lease: *Houlder Brothers* and *Sundance* both support that proposition.

Perhaps more convincing is Chief Justice Wittmann's overall assessment of (un)reasonableness in light of the dire circumstances facing PCR (and therefore ultimately IFP itself). Essentially PCR was sitting on a dying property in the form of a set of leases (although PCR did hold the freehold mineral title to some of the lands) that were going to expire or be cancelled unless somebody did some work on the property (and PCR certainly had no obligation to do that). Seen in this light the transfer to Wiser was a means of saving the properties and saving IFP's interest in those properties even if it might have prejudiced the adoption of thermal and enhanced recovery in the future. In other words, better the chance of the continuing possibility of future thermal and enhanced recovery (however remote) than the inevitable (and relatively immediate) loss of the properties. But if one takes this broad view of reasonableness then it might also be necessary to consider the extent to which the dire circumstances in which PCR found itself were inevitable or whether they were of PCR's own making.

What is the legal position where a working interest purports to withhold consent and the Court subsequently determines that the withholding of consent was unreasonable?

If a tenant assigns a lease in breach of the covenant not to assign or sublet without the landlord's consent (such consent not to be unreasonably withheld) the assignment or sublease is not invalid or void but the tenant is in breach of its covenant and the landlord will typically have reserved a right of re-entry for breach. Similarly, if the landlord withholds consent and the tenant believes the withholding to be unreasonable the tenant may elect to proceed knowing that if it can establish that the landlord's behavior is unreasonable it will not be in breach of its covenant. This is a high risk course of action since in the case of a lease the penalty for being wrong may be the loss of the lease. As a result, the assignee may well, as here, demand an indemnity. High risk it may be but it is a more expeditious way of proceeding than the alternative which is to apply for a declaration as to the unreasonableness of any withholding of consent (and note that under the CAPL the arbitration provisions of Article 24 apply to valuation issues in package deals; they do not apply to the consent issue).

The issue is a bit more complicated in the context of CAPL because of the novation provisions of the agreement – modified in this case and universally by the terms of the CAPL Assignment Procedure. These provisions are designed to provide for deemed novation in certain circumstances but the provisions can only be triggered if the parties are in compliance with the consent provisions.

In this case Chief Justice Wittmann concluded that the logic of all of this was applicable to the joint operating context and thus: (1) PCR was not in breach of the covenant not to assign without consent because consent was withheld unreasonably, (2) the deemed novation provisions were not precluded from applying by the absence of consent, and (3) therefore Wiser had been novated into the relevant agreements.

The reader may be wondering where this argument was going and who was on what side of it. The issue had been raised by IFP. IFP wanted to argue that if Wiser had not been novated into the JOA the provisions in the JOA that limited IFP's interest to an interest in thermal or enhanced recovery could not be enforced against IFP – IFP could then be taken to have an unqualified 20% undivided interest in the property. And on that basis IFP sought an accounting of its share of production relying on the *Statute of Anne*, 4 Anne c 16, s 27 (UK). Chief Justice Wittmann concluded (at paras 402- 403) that his earlier findings as to the limited nature of IFP's interest and his conclusion on the novation argument just referred to were a complete answer to the claim for an accounting.

Did the development of the property through primary production techniques substantially nullify the benefit for which IFP (B) had bargained so as to amount to a breach of contract?

It seems to me that Chief Justice Wittmann dealt with this issue in two parts of his judgement, first at paras 199-212 under the heading "4. What is the relevance of the reasonable expectations of the parties?' and then later at paras 220-270 under the heading "6. Has the opportunity to pursue a thermal or other enhanced recovery project at Eyehill Creek been destroyed or damaged?" In framing the issue in terms of substantial nullification rather than adopting the Chief Justice's headings I am drawing on Justice Kerans' judgement in the Court of Appeal in *Mesa Operating Ltd Partnership v Amoco Resources* (1994), 149 AR 187 (which the Chief Justice refers to at paras 199-201). I think that the Mesa case and the substantial nullification test referred to in that decision provide an appropriate umbrella for the consideration of these two

headings in part because there is no discussion of any applicable law under heading (6) in the chief justice's judgement. Thus it seems best to bring the "destroyed or damaged" framing of heading (6) under the *Mesa* umbrella.

In *Mesa*, Mesa held a GOR in half a section of lands and argued that Amoco breached its contractual obligations to Mesa when it carried out an administrative pooling of its lands on an acreage basis rather than on a reserves basis thereby effectively diluting Mesa's royalty entitlement. Amoco had the power to pool under the terms of the GOR agreement and thus the question was whether it had abused its discretion in the manner in which it went about exercising that power. The Court of Appeal concluded that this was a case in which pooling should have taken place on a reserves basis largely because it was able to say, considering the traditions and practices of the industry, that it was well established that "an operator pools on a reserves basis if the geographical data clearly shows the boundaries of the reservoir, and those boundaries are significantly at variance with the size of the corresponding surface parcels …". Given the unusual nature of the split rights in this case it was clearly going to be difficult for IFP to establish an analogous body of practice to support its contentions in this case.

Chief Justice Wittmann concluded that IFP could not make out its case under either of these two headings. IFP had not bargained for a prohibition on primary production (at para 212) (and thus that benefit was not in the contemplation of both parties and had not been nullified) and while there was much evidence that it would be more difficult and more expensive to introduce a thermal or enhanced recovery operation into a field that had been drilled out and depleted through conventional recovery measures and conventional cementing jobs, such an operation would not be impossible (at paras 267 – 268). In so concluding the Chief Justice establishes that *Mesa* sets a very high threshold. The application of the test does seem justified in this case because the parties clearly contemplated some continuing primary production, and, as the Court notes at para 195, given that, some level of conflict between those who own all the rights and those who only own some rights (the right to enhanced or thermal production) is inevitable.

Assuming that there was a breach of contract how should damages be assessed?

Although Chief Justice Wittmann concluded that PCR was not liable to IFP he did go on and consider whether IFP had been able to establish that it had suffered any damages. The Chief Justice posed three questions: (1) Was the claim of lost opportunity to develop the thermal and enhanced recovery potential of the property real or fanciful? (2) If real what was the value of the opportunity? (3) What was the likelihood that IFP would have been able to realize this opportunity and what discounting factor should be applied?

Chief Justice Wittmann concluded (at paras 284- 285) that the claim of lost opportunity was not merely fanciful. PCR disposed of the Eyehill Creek property for strategic reasons not because it believed that that the property had no potential for thermal development. He was less sympathetic to the plaintiff on the other two questions concluding (at para 364) that the plaintiff had been unable to establish any value for its lost opportunity and concluding further that there was zero chance that PCR would have initiated a thermal recovery operation in the absence of a farmout because of the poor economics and IFP would have been unable to initiate such an operation itself. I have not dug too deeply into these sections of the judgement but they seem very much to emphasise the economics of a thermal recovery project based upon oil prices at the time of the farmout. The rationale for focusing on the price environment at that time is that PCR would not have been able to hold on to the properties (see paras 377-378) and wait for prices to improve.

Assuming liability should any claim for damages be capped by a contractual agreement between the parties?

Article 9 of the AEA provided that in no event should PCR's liability to IFP exceed the value of the PCR assets. The parties assigned a value of $16 million to those assets; IFP's claim for damages was for $45 million. Chief Justice Wittmann commented as follows (at paras 405-406):

> On its face, a limitation of damages clause is legitimate and enforceable. IFP and PCR are sophisticated business entities who negotiated the AEA with the assistance of legal counsel. There is no indication of unconscionability or oppression at the time the contract was negotiated. There are also no public policy reasons to ignore the limitation clause.
> …. Given the language of the contract, IFP's claim for $45 million in damages was untenable.

Such limitation of damages clauses are common in purchase and sale agreements for oil and gas properties and confirmation of their enforceability will be welcomed.

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