OIL & GAS CONTRACTS

An ebook collection of ABlawg posts about upstream oil and gas contracts

JUNE 30, 2015

TABLE OF CONTENTS (hyperlinks provided)

INTRODUCTION, *NIGEL BANKES* **1**

SIGNALTA RESOURCES LIMITED v DOMINION EXPLORATION CANADA LIMITED, 2007 ABQB 636

WHAT ZONES WERE THE SUBJECT OF A UNITIZATION AGREEMENT?, *NIGEL BANKES* **3**

SIGNALTA RESOURCES LIMITED v DOMINION EXPLORATION CANADA LIMITED, 2008 ABCA 437

WHAT ZONES WERE THE SUBJECT OF A UNITIZATION AGREEMENT?, *NIGEL BANKES* **8**

ADECO EXPLORATION COMPANY LTD v HUNT OIL COMPANY OF CANADA INC, 2008 ABCA 214

THE LEGAL IMPLICATIONS OF FAILING TO CONTINUE A CROWN OIL AND GAS LEASE: THE DUTY OF THE OPERATOR TO ITS JOINT OPERATORS AND TO THE HOLDER OF A ROYALTY INTEREST, *NIGEL BANKES* **10**

NEXXTEP RESOURCES LTD v TALISMAN ENERGY INC ET AL, 2007 ABQB 788, AFF'D 2008 ABCA 246

WHAT HAPPENS WHEN THE DEEP RIGHTS YOU JUST PURCHASED ARE BEING DRAINED BY THE VENDOR'S SHALLOW RIGHTS WELL?, *NIGEL BANKES* **17**

TALISMAN ENERGY INC v ENERGY RESOURCES CONSERVATION BOARD, 2010 ABCA 258

WHAT'S THE NEXT STEP WHEN SHALLOW RIGHTS BECOME DEEP RIGHTS?, *NIGEL BANKES* **20**

NEXXTEP RESOURCES LTD v TALISMAN ENERGY INC, 2012 ABQB 62

DEEP RIGHTS, SHALLOW RIGHTS AND THE INTERPRETATION OF A PURCHASE AND SALE AGREEMENT, *NIGEL BANKES* **23**

HUSKY OIL OPERATIONS LIMITED v GULF CANADA RESOURCES LIMITED, 2008 ABQB 390

WHAT HAPPENS WHEN PARTIES OPERATE AN OIL BATTERY WITHOUT A FORMAL AGREEMENT?, *NIGEL BANKES & IWAN SAUNDERS* **27**

570495 ALBERTA LTD v HAMILTON BROTHERS EXPLORATION COMPANY, 2008 ABQB 413

WHEN DOES A ROYALTY OWNER NOT HAVE TO PAY FOR A SHARE OF PROCESSING COSTS?, *NIGEL BANKES* **32**

SOLARA EXPLORATION LTD v RICHMOUNT PETROLEUM LTD, 2008 ABQB 596

WHEN DOES A "PARTICIPANT" EARN UNDER THE TERMS OF A FARMOUT AND PARTICIPATION AGREEMENT?, *NIGEL BANKES* **35**

BROOKFIELD BRIDGE LENDING FUND INC v VANQUISH OIL AND GAS CORPORATION, 2008 ABQB 444

WHEN IS A NON-OPERATOR ENTITLED TO A CONSTRUCTIVE TRUST OVER THE OPERATOR'S OWN ASSETS?, *NIGEL BANKES* **40**

BROOKFIELD BRIDGE LENDING FUND INC v VANQUISH OIL AND GAS CORPORATION, 2009 ABCA 99

COURT OF APPEAL REJECTS THE CONSTRUCTIVE TRUST ANALYSIS IN BROOKFIELD, *NIGEL BANKES* **45**

BROOKFIELD BRIDGE LENDING FUND INC v VANQUISH OIL AND GAS CORPORATION, LEAVE TO APPEAL DENIED NOVEMBER 19, 2009

THE SUPREME COURT OF CANADA DENIES LEAVE IN BROOKFIELD, *NIGEL BANKES* **46**

MARATHON CANADA LTD v ENRON CANADA LTD, 2008 ABQB 408, 2009 ABCA 31

TERMINATING A LONG TERM GAS SALES CONTRACT ON ACCOUNT OF A MATERIAL ADVERSE CHANGE: THE CONTINUING FALLOUT FROM THE COLLAPSE OF THE ENRON EMPIRE, *NIGEL BANKES* **47**

SAN JUAN RESOURCES INC (RE), 2009 ABQB 55

CO-OWNERSHIP IS A MESSY BUSINESS (EVEN WITH AN OPERATING AGREEMENT), *NIGEL BANKES* **52**

BG INTERNATIONAL LIMITED v CANADIAN SUPERIOR ENERGY INC, 2009 ABCA 73, 2009 ABCA 127

EXTRAORDINARY TIMES JUSTIFY EXTRAORDINARY REMEDIES: INTERIM MEASURES UNDER THE AIPN STANDARD FORM OPERATING AGREEMENT, *NIGEL BANKES* **55**

BEARSPAW PETROLEUM LTD v CONOCOPHILLIPS WESTERN CANADA PARTNERSHIP, 2009 ABQB 202

RIGHTS OF FIRST REFUSAL IN A PACKAGE SALE OF OIL AND GAS PROPERTIES: A FOLLOW UP TO CHASE MANHATTAN, *NIGEL BANKES* **59**

HUNT OIL COMPANY OF CANADA INC v SHELL CANADA LIMITED, 2009 ABQB 627

WHEN, IF AT ALL, DOES A POOLING AGREEMENT TRIGGER AN AREA OF MUTUAL INTEREST OBLIGATION?, *NIGEL BANKES* **62**

LYATSKY GEOSCIENCE RESEARCH AND CONSULTING LTD v GEOCAN ENERGY INC, 2009 ABPC 392

PROVINCIAL COURT ROYALTY CALCULATION DECISION, *NIGEL BANKES* **66**

DIAZ RESOURCES LTD v PENN WEST PETROLEUM, 2010 ABQB 153

CHALLENGE NOTICES UNDER THE TERMS OF THE 1990 CAPL OPERATING PROCEDURE, *NIGEL BANKES* **69**

NAL GP LTD v BP CANADA ENERGY COMPANY, 2010 ABQB 626

INJUNCTION DENIED IN OIL AND GAS RIGHT OF FIRST REFUSAL CASE, *NIGEL BANKES* ... **72**

TRIDENT EXPLORATION CORP (RE), 2012 ABQB 242

MORE GRIST FOR THE MILL, ANOTHER CASE OF GROSS NEGLIGENCE UNDER CAPL 1990, *NIGEL BANKES* **74**

BAYTEX ENERGY LTD v STERLING EAGLE PETROLEUM CORPORATION, 2012 ABQB 539

ISSUANCE OF A NOTICE OF ABANDONMENT UNDER CLAUSE 1201 OF CAPL IS AN ATTEMPT TO EXERCISE A "RIGHT TO REMEDY" WITHIN THE MEANING OF THE TYPICAL STAY PROVISIONS OF A RECEIVERSHIP ORDER, *NIGEL BANKES* **76**

TRIBUTE RESOURCES v 2195002 ONTARIO INC, 2012 ONSC 25, 2195002 ONTARIO INC v TRIBUTE RESOURCES, 2012 ONSC 5412

NATURAL GAS STORAGE RIGHTS IN ONTARIO: QUESTIONS OF JURISDICTION AND INTERPRETATION, *NIGEL BANKES* **78**

2195002 ONTARIO INC v TRIBUTE RESOURCES INC, 2013 ONCA 576

ONTARIO COURT OF APPEAL CONFIRMS THAT THE COURTS HAVE SOME RESIDUAL JURISDICTION OVER NATURAL GAS STORAGE MATTERS, *NIGEL BANKES* **83**

CAMPION ET AL v RADOMSKI ET AL, 2012 MBQB 267

MANITOBA DECISION ON THE ASSIGNMENT OF A ROYALTY INTEREST, *NIGEL BANKES* .. **85**

CANADIAN NATURAL RESOURCES LIMITED v JENSEN RESOURCES LTD, 2012 ABQB 786

WHEN IS A LEASE ISSUED "IN LIEU" OF AN EXISTING LEASE?, *NIGEL BANKES* **90**

CANADIAN NATURAL RESOURCES LIMITED v JENSEN RESOURCES LTD, 2013 ABCA 399

LIMITATIONS ISSUES IN OIL AND GAS ROYALTY LITIGATION, *NIGEL BANKES* **93**

EOG RESOURCES CANADA v UNCONVENTIONAL GAS RESOURCES CANADA OPERATING INC, 2013 ABQB 105

A FARMEE THAT SPUDS IN THE TEST WELL HAS THE RIGHT TO A DEFAULT NOTICE, *NIGEL BANKES*.......... **96**

TALISMAN ENERGY INC v ESPRIT EXPLORATION LTD, 2013 ABQB 132

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!, *NIGEL BANKES* **99**

CANADA CAPITAL ENERGY CORPORATION v BARRACUDA ENERGY LTD, 2013 SKQB 134

SUMMARY JUDGMENT TO RECOVER MONIES OWING UNDER A UNIT OPERATING AGREEMENT, *NIGEL BANKES* **103**

ELECTRICITY GENERATION CORPORATION v WOODSIDE ENERGY LTD, 2014 HCA 7

DECISION OF THE HIGH COURT OF AUSTRALIA OF INTEREST TO CANADA'S ENERGY BAR, *NIGEL BANKES*.......... **105**

BLAZE ENERGY LTD v IMPERIAL OIL RESOURCES, 2014 ABQB 326

SWIFT JUDGMENT IN A COMPLEX COMMERCIAL CASE, *NIGEL BANKES* **109**

IFP TECHNOLOGIES (CANADA) v ENCANA MIDSTREAM AND MARKETING, 2014 ABQB 470

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?, *NIGEL BANKES*.......... **113**

BERNUM PETROLEUM LTD v BIRCH LAKE ENERGY INC, 2014 ABQB 652

GROSS NEGLIGENCE AND SET-OFF RIGHTS UNDER THE 2007 CAPL OPERATING PROCEDURE, *NIGEL BANKES* **122**

SEMSCAMS ULC v BLAZE ENERGY LTD, 2015 ABQB 218

SUMMARY JUDGMENT ON CONTESTED AMOUNTS OWING UNDER NATURAL GAS PROCESSING AND RELATED AGREEMENTS, *NIGEL BANKES*.......... **125**

Introduction: By Nigel Bankes

This ebook collects a set of ABlawg posts dealing with upstream oil and gas contracts between 2007 and June 2015.

Most of the posts in this collection deal with the standard form agreements of the Canadian Association of Petroleum Landmen (CAPL) including the farmout agreement (*EOG Resources v UCRC*, *Solara v Richmount*), the operating agreement (*Adeco v Hunt*) and, the property transfer agreement (*Nexxtep v Talisman*). Other posts cover unitization arrangements (*Signalta v Dominion*), gas processing agreements, pooling agreements (*Hunt v Shell*) and agreements to construct, own and operate facilities (e.g. *Talisman v Esprit*). Most of the posts deal with lands in Alberta and decisions of the Alberta courts but there are also decisions from other provinces, one decision which deals with an AIPN (Association of International Petroleum Negotiators) form (*BG International v Canadian Superior*) and even one post which covers a decision of the High Court of Australia (*EGC v Woodside*).

Many of these posts deal with issues of contract interpretation, but many also shed light on particular terms and concepts used in the industry including independent operations, rights of first refusal (ROFR) (*Bearspaw v Conoco, Blaze v Imperial*), the operator's lien, the obligations of the operator to non-operators, the gross negligence standard (*Re Trident*; *Bernum v Birch Lake*), fiduciary obligations, (*Brookfield v Vanquish*) and the removal or challenge of an operator (*Diaz v Penn West*).

I am not sure that I can identify common themes within these cases and perhaps it is more important that the reader be sensitive to the need to read and examine these cases in light of more general developments in contract law as well as the law on summary judgement. As for general contract law, two cases are of particular note: *Bhasin v Hrynew*, 2014 SCC 71 and *Sattva Capital Corp v Creston Moly Corp*, 2014 SCC 53. Professor Watson Hamilton posted on the relevance of *Sattva* for arbitration award appeals here. Professor Girgis posted on the Alberta Court of Appeal's arcane decision here but we have no post on the Supreme Court of Canada's decision overturning that of the Court of Appeal.

The *Bhasin* decision is important because it recognizes (at para 93) that "There is a general organizing principle of good faith that underlies many facets of contract law" and recognizes as a manifestation of that general principle "a new common law duty …. of honest performance which requires the parties to be honest with each other in relation to the performance of their contractual obligations." In light of this it will be important to consider the implications of this decision for the implementation of discretionary obligations under oil and gas contracts. The Court does refer to one oil and gas case (a pooling case *Mesa Operating Limited Partnership v Amoco Canada Resources Ltd* (1994), 149 AR 187) (Alta CA)) in its decision but the case also has implications for *inter alia* the ROFR provisions of the operating agreement: see *Chase Manhattan Bank of Canada v Sunoma Energy Corp.*, 2002 ABCA 286. A paper prepared by Neil Finkelstein, Brandon Kain, Craig Spurn, Seán C. O'Neill and Justin H. Nasseri for the Jasper Energy Law Foundation Conference (June 2015) provides an excellent discussion of *Bhasin* in the oil and gas contract context: "Honour Among Businesspeople: The Duty of Good Faith and Contracts in the Energy Sector".

The *Sattva* decision is principally important, as Professor Watson Hamilton notes, for changing the law on the deference to be accorded to arbitrators and trial judges in the interpretation of

contracts. The Court decided that, given the importance of the commercial and factual matrix within which a contract is negotiated, the interpretation of the resulting arrangements will give rise to mixed questions of law and fact. Consequently, the standard of review to be applied to such interpretations is likely to be reasonableness rather than correctness. It remains to be seen whether this deferential standard of review will be equally applicable to both bespoke and standard form contracts.

Developments in the law on summary judgement (the principal case here is *Hryniak v Mauldin*, 2014 SCC 7) will have profound implications for the way in which parties litigate all manner of commercial disputes. One interesting example in this ebook is provided by the post on Justice Jo'Anne Strekaf's recent decision in *SemCAMS ULC v Blaze Energy Ltd*.

This ebook is organized chronologically by date of post (oldest first) except that we have grouped together trial and appellate decisions so that any appellate decisions are printed immediately after the trial or first instance decision. Where appropriate the text also includes any commentary and response received on the individual posts. There is no index to the volume but it should be readily searchable in this electronic form using key words and the "find" function in adobe acrobat or equivalent.

I am responsible for the selection of posts for this volume. Evelyn Tang (JD 2016) has been responsible for the hard work in knitting this all together.

November 11, 2007

What Zones Were the Subject of a Unitization Agreement?

Written by: Nigel Bankes

Case Commented On: Signalta Resources Limited v Dominion Exploration Canada Ltd, 2007 ABQB 636

The question of what substances are the subject of a unitization has been before the courts on at least one other occasion in *Prism Petroleum Ltd v Omega Hydrocarbons Ltd*, [1994] 6 WWR 585 (Alta. C.A.). The issue in that case involved a split petroleum and natural gas title. *Signalta v. Dominion* does not involve a split title in that sense. Rather the issue was whether the title that had been committed to a unitization agreement was confined to the Viking or whether it also included the Glauconite. Put in these terms the issue seems relatively simple but the paper trail was very complex. Combine a complex set of facts with competing expert opinions from well known legal (Ballem and Thackray) and land (O'Byrne) experts and the result is a very lengthy 74 page judgement from Justice A.G. Park in which he concluded that the Glauconite for the relevant tract was never included in the original unitization.

The issue in Signalta came to the fore when in late 2000 Dominion completed and began producing for its own account a well in the Glauconite some 25 years after the effective date (February 1, 1975) of the original unitization agreement. Signalta claimed that the well was producing from the unitized zones; Dominion took the opposite view and, in case it was unsuccessful, argued that Dominion could recover damages from Signalta for negligent misrepresentation.

The lands in issue are variously described as the section 8 lands or the Tract 29 lands of the West Viking Gas Unit # 1. The section 8 lands were originally owned by Hudson's Bay Oil and Gas (HBOG). But by the terms of a 1973 agreement covering various parcels HBOG transferred the mineral title to the section 8 and other lands to Siebens, reserving to HBOG the right to acquire petroleum and natural gas leases to these lands. HBOG then entered into a multi-section farmout agreement with Dyco (the predecessor in title to Dominion) on April 25, 1974. This agreement required Dyco to drill 26 wells on locations of its choice on the Scheduled lands with priority to be accorded to lands that were subject to offsetting drainage. The wells were all to be drilled to "contract depth" and tested and completed or abandoned by July 31, 1975. Contract depth was defined as a "depth sufficient to penetrate One Hundred Feet (100') into the Formation indicated or to the total subsurface depth which appears opposite each Bay parcel [as described in Schedule A] ….." The earnings clause in turn provided that having fulfilled its obligations the Farmee would be entitled to a sublease "of all of the Farmor's rights and interests "of all of the Farmor's rights and interests in and to …. [the selected lands] … insofar as such rights and interests relate to all formations down to the stratigraphic equivalent of contract depth or depth drilled, whichever is greater, described in Schedule "A" opposite each respective Bay Parcel …". Various passages in the judgement (e.g. at paras 245 and 269) suggest that the entry opposite the Section 8 lands must have read "the Viking Formation" or words to that effect. This finding was crucial to the resolution of the case.

Shortly before HBOG entered into the farmout agreement, Voyager, a predecessor in title to Signalta, started to canvass parties with respect to forming the West Viking Unit. HBOG attended the first few meetings but then (December 1974) advised Voyager that all future correspondence should be addressed to Dyco and from thenceforward it was Dyco that attended all the relevant meetings. Fairly early on in the negotiations it emerged that there were two mapable reservoirs that might be the subject of the unitization, the Viking and the Glauconite but the treatment of the Glauconite Formation for Tract 29 was not always dealt with consistently.

The Unit Agreement was finalized in December 1974 and copies sent out for counterpart execution. The Agreement was expressed to have an effective date of February 1, 1975. At the first meeting of the operating committee in January 1975 all titles but for Tract 29 were approved on the recommendation of the Titles Committee. Tract 29 was not approved since Dyco could not as yet show a title to these lands. It was understood that Tract 29 would be qualified for admission (as of the effective date) if Dyco could establish its title by May 1. Dyco and HBOG ultimately entered into two agreements in April 1975, one being an agreement to provide Dyco with a sub-lease and the other being the sub-lease itself which granted all of the leased substances down to the base of the Viking. It did not as Justice Park explained (at para 50) grant any deeper rights since "Dyco had not drilled on the Section 8 lands and accordingly was entitled only to earned (sic) interests to contract depth set out in the Farmout Agreement, being to the base of the Viking Formation". The sublease was stated to have a date of execution of January 31, 1975. On May 1, 1975 the Operating Committee accepted the recommendation of the title committee to include Tract 29. At about the same time Dyco drafted a letter to HBOG in which Dyco acknowledged that its sub lease did not give it rights to the Mannville and sought to have HBOG amend the sub-lease to include those rights. There was no evidence that the draft letter was ever finalized and sent and received by HBOG and the sublease was never amended.

The Unit Agreement was executed in counterpart as follows: Voyager, December 20, 1974 (as a WIO (Working Interest Owner) and proposed unit operator), Dyco January 13, 1975 (as a WIO), Siebens February 21, 1975 (as a Royalty Interest (RI) owner). HBOG executed it on February 26, 1975 although it was unclear as to whether HBOG executed as a WIO and\or as a RI owner. Between the time that the Agreement was first sent out for execution and May 1 the Agreement was subject to an amendment which related to Tract 29. Thus while the agreement as first sent out showed HBOG as the WIO of Tract 29 and the Glauconite was not included as an excepted zone, revision # 1 (stated to have an effective date of February 1, 1975) showed Dyco as the WIO for Tract 29. But the Agreement still did not list the Glauconite as an excepted zone.

In 1992 Poco as successor in interest to Voyager as the operator issued amendment # 13 to the Unit Agreement in which it inter alia revised exhibit A to include the Glauconite as an excepted zone for Tract 29 (at para 64). That remained the position until nearly two years after Dominion drilled the 13-8 well when Signalta (the successor in interest to Voyager and Poco) took the position that the Glauconite was within the unit and proposed to reimburse Dominion for the costs of drilling and completing the 13-8 well.

In sum, there was at the very least considerable confusion at the time the original unitization was completed as to whether Tract 29 included the Glauconite or was limited to the Viking.

Given the state of the title it would seem that there were two possible ways in which the Glauconite might have been included in the unitization. First, Dyco might have dedicated the Glauconite to the unit. Certainly the Glauconite was not excluded from the unitization documents when Dyco executed the agreement. But the fatal flaw in this argument was that Dyco never

became entitled to the Glauconite under the terms of its farmout agreement with HBOG. Dyco's earning was confined to the Viking zone and the sublease that HBOG executed properly reflected that conclusion. On this analysis the fact that the Glauconite for Tract 29 appeared to be included in the unitization documents was simply a mistake (at para 280) and a mistake that was ultimately corrected by Poco in 1992 (at paras 247 and 272 – 276). Poco was entitled to do this without obtaining the consent of the parties to the Agreement precisely because it was a "mistake or mechanical error" within the meaning of cl. 203 of the Unit Agreement.

The second possibility was that HBOG might have contributed the Glauconite. After all, if Dyco didn't have rights to the Glauconite HBOG certainly did under the terms of the head lease with Siebens. Furthermore, HBOG did execute the Unit Agreement, and as Signalta pointed out (at para 223), the unit agreement did contain the typical clause to the effect that if a party owns a WI as well as a royalty interest, its execution of the agreement shall constitute execution in both capacities. But there were weaknesses in this argument as well. Thus, while the original version of the Unit Operating Agreement did refer to HBOG as the owner of the WI in Tract 29 (at para 229), Dyco became listed as the WIO of Tract 29 by Revision # 1 which had an effective date of February 1, 1975. Furthermore, it appeared that HBOG was never a party to the unit operating agreement or at least (at para 228) there was no evidence that it had ever executed the operating agreement; HBOG did not execute authorizations for expenditure (AFEs) related to the unitization; HBOG did not sit on the operating committee; and HBOG did not receive revenues as a WIO (at para 255). In sum there was no evidentiary basis to call clause 1302 in aid.

Justice Park's principal conclusion on all of this was as follows (at para 234):

> In any event, I do not accept Signalta's argument in this area. Rather it is my view the Glauconite formation in Tract 29 [Section 8] was not committed to the Unit by HBOG or Dyco at the effective date of the Unit, being February 1, 1975. I am of the opinion the Unit's Title Committee misunderstood the title and interest Dyco conveyed to the Unit. This misunderstanding was based on the assumption HBOG was conveying to Dyco all of HBOG's Working Interest ownership as set out in Exhibit "A" in the August, 1974 draft Unit Agreement. HBOG did not convey all that Working Interest in Tract 29 [Section 8] to Dyco. Rather it only contributed its Working Interest ownership, as defined in the sublease, to Dyco, to the base of the Viking formation.

One of the implications of concluding that the Glauconite for Tract 29 was not included was that the reserves allocation for Tract 29 was overstated since there was general acknowledgement and the court so found (at para 271) that the tract participation factor for Tract 29 as included in Exhibit A was calculated on the basis of both formations being included. In effect this meant that by mistake (whether of fact or law) the WI and RI parties interested in Tract 29 had received more benefits than they were entitled to over the years. But this, said Justice Park, was another issue and an issue that might perhaps present itself as a claim for unjust enrichment (at para 272).

One of the intriguing aspects of the case was the battle of the experts. The plaintiffs, perhaps most conventionally, called experts who could testify as to customs in the industry with respect to unitization and related matters. These experts included O'Byrne and Moller. The defendants by contrast called two well-known Calgary lawyers to testify on a number of issues which seem to have elicited their opinions on a variety of legal issues including "the ultimate question". Indeed Justice Park acknowledged that at least three witnesses (Ballem, Thackray and O'Byrne) provided evidence as to the ultimate question before him (at paras 260, 264) but only Ballem's

was treated as inadmissible. Ballem's evidence was treated as inadmissible on two separate grounds. First, his expert opinion did not meet the definition of necessity (at para 201):

> His opinion on contractual issues, interpretation of legal agreements and documentation is a legal opinion which falls within the ordinary experience of this Court. It is knowledge which is based upon ordinary legal principles of the law. I can apply and determine the law in this area of contractual issues and legal documents as I interpret it based upon the evidence and the arguments of Counsel on the law. I can and will form my own conclusions without the assistance of Ballem. There is a sufficient factual basis present to allow me to deal with these issues.

And, second, his evidence was treated as inadmissible on the basis that the evidence as filed provided only conclusions and not the reasoning behind those conclusions (at paras 202 – 205). While Ballem provided this reasoning in his viva voce evidence this was too late to allow the plaintiffs to adequately prepare their case.

O'Byrne's evidence suffered a different fate. Justice Park noted that O'Byrne was qualified as an expert on the basis of industry practice and custom (at para 260). Thus, in order for his evidence as to the proper interpretation of a clause in the agreement (in this case the farmout agreement) to be given any weight (or perhaps even regarded as admissible) it must be based upon industry practice and custom. O'Byrne did not buttress his opinion as to how the relevant agreements should be interpreted by referring to industry practice and consequently his evidence was disregarded. It didn't help that Justice Park simply disagreed (at para 262) with many of the legal interpretations of this non-legally- qualified witness.

A couple of other issues arose that are also perhaps worthy of comment even though not central to the outcome of the case. The first was the applicability of the "failure of title" provisions of the unit agreement. Unit agreements typically provide (as did this agreement, cl. 1103 at para 277) that where a party's title fails the tract shall be excluded from the unitization agreement unless another Party to the Agreement shall be held to own the title in which case that Party shall be bound by the Agreement in respect of the tract. Justice Park held that these provisions were simply inapplicable (at para 241). The title to the Glauconite formation could not fail as the title or interest to the Glauconite formation never passed to Dyco as a WIO. For a failure of Dyco's title to the Glauconite formation to occur, Dyco would have to own or possess rights to such a title. It never owned or possessed a right or an interest to the Glauconite formation because it never earned such a right or an interest under the Farmout Agreement (at paras 278 – 279). And similarly, HBOG could not be held to be bound by this clause of the Agreement since again this was not a case of title failure but a case of the lands never having been made a part of the Agreement.

Second, there was also a brief limitations discussion in the case. The question was when the two year period would have started to run. Dominion argued that it should have started to run from November 2000 when it wrote to Signalta trying to get access to the processing plant for production from its 13-8 well. But there was a snag with that argument since at that time Dominion by mistake indicated that the well was producing from the Colony (which was not

unitized) formation rather than the Glauconite. Justice Park held that it was reasonable for Signalta to rely upon this representation (that the well was producing from the Colony) and that Signalta did not have a duty to ensure for other unit holders that Dominion was not draining substances from the unit (at para 297).

Since Dominion was entitled to the production from the 13-8 well it followed that no damages were payable by Dominion for unlawful production. But Justice Park still offered his views on how damages should be calculated. And he concluded, following *Montreal Trust Co. v Williston Wildcatters Corp*, [2004] SKCA 116, (leave to appeal to the SCC refused)7 that damages should be based on the mild rule. But what did that mean here in the very different context of competing working interest ownership rather than a dead lease? It would mean that Dominion would have to pay revenues received from the sale of the produced substances minus an amount for drilling and operating costs and any amounts payable as royalty. There was another accounting issue to be settled and that related to Signalta's action against the Crown since the Crown seems to have included (at para 6) production from the 13-8 well in production from the unit. The Court ordered that Signalta was entitled to an accounting for any such monies paid. I commented on this case at length in (2005), 68 Sask. L. Rev. 23 – 77. Justice Park did not refer to the more recent judgement of Justice Kent in *Freyberg v Fletcher Challenge Oil and Gas Inc*, [2007] ABQB 353.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

December 27, 2008

What Zones Were the Subject of a Unitization Agreement?

Written by: Nigel Bankes

Cases Commented On: *Signalta Resources Limited v Dominion Exploration Canada Ltd*, 2007 ABQB 636; *Signalta Resources Limited v Dominion Exploration Canada Ltd*, 2008 ABCA 437

I blogged the trial decision of Justice AG Park in this case and now the Court of Appeal has affirmed. Readers wanting a full statement of the facts should review that earlier blog.

There were, as the Court put it, "no grounds for appellate intervention" (at para. 2) and in particular the Court of Appeal agreed with Justice Park that the original inclusion of the Glauconite for the section 8 lands in the schedule to the unitization agreement was a mistake. It was a mistake for two reasons: (1) Dyco (Dominion's predecessor in title) did not have rights to the Glauconite under its farmout with Husky and therefore could not contribute Glauconite rights, and (2) Husky (which did own the Glauconite rights) never contributed them and executed the relevant agreements as a royalty owner and not as a working interest owner.

In the course of its short memorandum of judgement the Court (Justice Clifton O'Brien, Justice Peter Martin and Justice Bryan Mahoney) did comment on several clauses of the standard form unitization agreement, clauses 203, 204 and 1302.

Clause 1302 provides that:

> *If a Party owns a Working Interest and a Royalty Interest, its execution of this agreement shall constitute execution in both capacities.*

The Court made two points about this clause. First, it could not possibly mean that a party must necessarily be taken to be contributing whatever interest in had in a particular tract. It was always open for a party to signify a contrary intention. Second, evidence of that contrary intention might take the form of an explicit statement or reservation but it might also take the form of extrinsic evidence which would be admissible (at paras 41 – 42).

> …. it is implicit in the wording of clause 1302 that it applies only to the working interests and royalty interests intended to be committed and bound by the agreement. The clause is there as a matter of convenience to alleviate the need for the party holding dual interests to sign the document twice, or more, in such circumstances. Its purpose is not to commit both interests, when it is understood by the parties at the time that only one or the other interest is being committed to the unit …. extrinsic evidence could be admitted to establish that HBOG executed the agreement only in its capacity as a royalty owner, and that it never intended to contribute the Glauconite formation in which it had the working interest.

Clauses 202 and 203 provide as follows:

> 202. Each exhibit shall be deemed conclusively to be correct to the effective time of a revision or correction thereof as herein provided.
>
> 203. If any mistake or mechanical error occurs in an exhibit, Unit Operator may, or upon request of the Working Interest Owners shall, prepare a corrected exhibit but the data used in establishing Tract Participation shall not be re-evaluated.

Clause 203 was of central importance since at some point Poco, the then operator, had amended the schedules to exclude the Glauconite. If inclusion of the Glauconite was a mistake then it followed (and this seems to have been assumed by both the trial court and the court of appeal (at para 35) and this is a significant point) that Poco could rely on cl. 203 and make the amendment and that this amendment was binding on Signalta as the successor operator.

The Court commented on clause 202 as part of its discussion of the dual capacity of execution point. In essence the Court seems to have been saying something like the following:

> if the amended schedule does not include the Glauconite then, in light of cl. 202, and given the importance of reading the agreement as a whole (at para 43) how was it possible to argue that Husky must necessarily have executed the agreement in a joint capacity and as such contributed its working interest in the Glauconite? The most that could be said for the argument was that there was an ambiguity (at para 44) which Husky was entitled to resolve by adducing extrinsic evidence.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

June 16, 2008

The Legal Implications of Failing to Continue a Crown Oil and Gas Lease: The Duty of the Operator to its Joint Operators and to the Holder of a Royalty Interest

By: Nigel Bankes

Cases Commented On: *Adeco Exploration Company Ltd v Hunt Oil Company of Canada Inc*, 2008 ABCA 214; varying unreported oral reasons for judgment of May 3, 2007

One of the most important events in the life of a Crown oil and gas lease or licence in Alberta is the point of continuation at the end of the primary term (a lease) or at the end of the intermediate term (a licence). It is important because a lease or licence lapses at the end of its primary or intermediate term except to the extent that it is continued (*Mines and Minerals Act*, R.S.A. 2000, c. M-17, s.82(1)). And when a lease lapses as to some or all of the leased area so too will any royalty interests with respect to that area of the lease.

The current rules on continuation are prescribed in the *Petroleum and Natural Gas Tenure Regulations* (Alta. Reg. 263\1997). They are applied on a spacing unit by spacing unit basis. If there is a well capable of production on any spacing unit within the area of the Crown lease, that spacing unit is continued down to the deepest formation capable of production (*Tenure Regulations* s.15(1)(a)).

But where the spacing unit has not been drilled out and the spacing unit is not included within the area of a unitization agreement, the lease\licence will only be continued for that spacing unit to the extent that the lessee (and in particular the authorized representative of the lessee since in a co-owned well the Crown wants to know with whom it has to deal) can show to the satisfaction of the Department that the spacing unit is capable of production (s.15(1)(e)). This makes sense in societal terms. We do not want to encourage the drilling of unnecessary wells since each well increases the ecological footprint of the industry and the capital spent on each well potentially dissipates the amount of economic rent that the Crown can collect. So if our lessee can show by drill results and mapping that the spacing unit would be productive if drilled and that the reserves underneath that spacing unit are in fact being produced from offsetting wells also on Crown property then that spacing unit will be included in the continuance decision. But outside the spacing unit of the producing well(s) the onus is clearly on the lessee to adduce the evidence before the Department to make that case.

And to aid the lessee\licensee in that endeavour the Department produces a number of information letters and guidelines and offers the lessee the opportunity to meet with Departmental staff to allow the lessee to make its best case with whatever information it has available: (e.g. Information Letter, IL 2008-13 Continuation of Petroleum and Natural Gas Leases and Intermediate Term Licences, Continuation Application Guide and Technical Guidelines for Continuation.) And these documents emphasise that certain types of information are "useful" in support of an application whereas others are "essential". Amongst the data

described as essential to support an application under s.15(1)(e) of the *Regulations* is mapping, isopach, net pay or structural mapping with supporting cross sections as appropriate.

So what happens if the authorized representative of the lessee fails to put its best foot forward in a case such as this and, as a result, the Department authorizes continuance for the drilled spacing units but fails to authorize continuance for the undrilled spacing units in the lease? May the representative be liable to its co-owners? And may the representative be liable to a party with a royalty interest? And if the answer is "yes" in either case on what basis – contract, tort, co-ownership obligations or fiduciary duty?

These were the issues in *Adeco v. Hunt* and the courts found Hunt liable both to its co-owners (Adeco (A) and Shaman(S)) and to the royalty owner (Rama) on the basis of breach of contract. Assessment of damages will follow.

The Facts

The facts were basically as outlined above; Hunt held a 75% interest in two leases, Adeco a 16.66% interest and Shaman an 8.33% interest. The leases were subject to a JOA that used the 1990 CAPL (Canadian Association of Petroleum Landmen) form. Rama held a 3% overriding royalty interest which it obtained in return for bringing these properties to the attention of Hunt et al. There was an undrilled spacing unit on each of the leases. Hunt waited until the last day to file its application for continuation but prior to that it had confirmed with A & S that the application should include the undrilled spacing units. Hunt included well logs and recent production data in support of the application but did not include an interpretive map. Three months later the Department wrote back indicating that it would continue for all the leased lands except the undrilled spacing units but it did advise Hunt that it could supply additional data to support its application for these two parcels within a month. Hunt made internal inquiries, determined that it had no further information to submit and as a result did not submit further supporting information. Hunt did provide a copy of the Department's letter to A & S. Subsequently when the lands were put up for bid Hunt submitted an offer to reacquire the lands but was unsuccessful. At trial, evidence was led tending to show that the lease would have been extended as to these two units had Hunt provided supporting mapping and that the preparation of such a map should have been a relatively straightforward exercise based on information that Hunt would have had to hand.

In addition to the 1990 CAPL Agreement, the royalty agreement between all of the parties included: (1) a grantor's covenant to make all required payments etc. and to keep the leases "not [to] allow the Said Leases to terminate or become subject to forfeiture"; (2) a covenant not to surrender the leases or any portion thereof without providing Rana with notice and an opportunity to take an assignment, and (3) a liability and indemnity covenant in which the grantors acknowledged liability and a duty to indemnify for all losses, damages, costs etc incurred by Rama as a result of "any act or omission … with respect to operations or activities conducted by [the grantor]".

Judgement at Trial

The trial judge (Justice Miller) in short oral unreported reasons concluded that Hunt had breached its obligations to A & S under cl. 309 of the 1990 CAPL to maintain the title deeds and that Hunt was not exonerated from this liability by cl. 401 (which purports to limit the operator's liability to its joint operators except in cases of gross negligence or willful misconduct). Justice

Miller also held that Hunt was in breach of a fiduciary duty which it owed to each of the defendants – Rana, A & S. And finally, Justice Miller held that Hunt was liable to Rana on the terms of the royalty agreement and rejected Hunt's effort to third party A & S to reduce its direct liability to them on the basis of contributory negligence and to have them share the contract-based joint and several liability of the grantor to Rana under the terms of the royalty agreement.

Judgement on Appeal

The Limitation on Liability

In a unanimous reserved judgement for the Court of Appeal Justice Keith Ritter (writing also for Clifton O'Brien and Patricia Rowbotham JJ.), confirmed the result reached at trial but for rather different reasons. Unlike Justice Miller the Court of Appeal concluded that the cl. 401 successfully excluded the operator's liability for damages suffered by joint operators as a result of negligence. This exclusion of liability did not just apply to the cl. 304 duty to conduct all joint operations diligently in a good and workmanlike manner, in accordance with good oilfield practice but extended to other specific contractual duties such as the cl. 309 duty to maintain the title documents in good standing.

I think that this is absolutely correct. Unlike the situation in a farmout where the farmee conducts the operation at its sole cost, risk and expense, all operations (except independent operations) conducted under the operating agreement are shared risk operations. The parties assume some risk of negligence and the operator is not an insurer of that risk.

In reaching this conclusion the Court referred to Justice Hunt's judgement in *Erehwon v Northstar* ((1993), 108 DLR 4th 709) and her distinction between liability as between the parties to the agreement (operator liable for mere negligence) and liability arising from a loss suffered by a third party (liability for the joint account unless operator grossly negligent) but did not overrule her approach. Instead the Court preferred to distinguish *Erehwon* on the basis that it was a decision on the 1981 CAPL and that the 1990 CAPL demanded a different result because it distinguishes clearly between liability and the duty to indemnify (at para 42).

It is not clear to me that it is possible to distinguish *Erehwon* quite so easily. Notwithstanding the Court of Appeal's decision in *Mobil Oil v Beta* (1974), 43 DLR (3d) 745 there is nothing about the concept of indemnity that confines it to the third party situation (*TransCanada Pipelines v Potter Station Power* [2003] OJ 1879). It may simply be the case that the agreement does not support the distinction that Justice Hunt made in *Erehwon* and if the industry wants to make that distinction it will need to do so in the drafting of the CAPL Agreement. It seems to me that this is precisely what the drafters of CAPL 2007 have tried to do (see the new cl. 4.01).

The Gross Negligence Standard

While this conclusion certainly served to correct Justice Miller's (mis)interpretation of the 1990 CAPL it left outstanding the question of whether or not Hunt might still be liable for the loss of part of the lease on the basis that its failure to prosecute lease continuance was not merely negligent but was actually grossly negligent. One might have thought that this was an area in which an appeal court would be loath to tread since this is mixed fact\law issue and the standard for review is that of palpable and overriding error. But it must be appreciated that in this case the trial judge had not made a determination on this point since he didn't need to. Justice Miller took the view that mere negligence was enough to ground liability and did not address himself to the

question of gross negligence. That, as Justice Ritter noted (at para 49) left the Court of Appeal with two options, send it back to trial or decide the question on the basis of the existing record. The court plumped for the second option and on the basis of its assessment of the record concluded that Hunt Oil was indeed grossly negligent.

The Court's approach to this question followed four steps. First, the Court examined just what it was that Hunt had done or had failed to do. Here (at paras 50 – 54) the Court noted that: Hunt left everything until the last day (not itself evidence of even negligence); upon receipt of the deficiency letters the relevant employee made some further inquiries but concluded that there was no further information available to file; the case was an easy case, "a simple matter" and, contrary to what Hunt's employee had concluded, the information was available or could have been produced with minimal effort; the relevant instructions were readily available on the web; Hunt had an internal system that worked when all went well but was woefully inadequate to deal with any situation where a problem was encountered.

The second step in the reasoning was for the Court to conclude that all of the above taken together amounted to negligence (at para 55).

The third and crucial step was to move from a negligence categorization to a gross negligence categorization. As part of that the Court analysed some of the case law dealing with the gross negligence standard (at para 55) drawing upon two cases dealing with the liability of municipal governments, one gratuitous passenger case, one oil and gas law case from Alberta and one case from Texas. From these cases emerged such key phrases as "very great negligence", "conscious wrongdoing". "marked departure" from the required standard, and "conscious indifference". Relevant questions to ask as part of the analysis include the character and duration of the neglect and the comparative ease of discharging the duty.And as a fourth step the Court applied these dicta to the facts holding that Hunt's system for dealing with continuance was not just flawed, "it did not come close" to what was required (at paras 56 and 57):

> [56] Hunt Oil argues it was not consciously indifferent since it had a system for renewal in place. However, as I have stated, that system involved a great deal of *ad hoc* response to crises by personnel lacking requisite knowledge and skills. It was a system that contemplated no problems, and no doubt worked so long as the continuation involved leases on producing lands. It did not come close to addressing what was required for continuations on non-producing lands.
>
> [57] What Hunt Oil did may be likened to a system in a law office in which an untrained, unknowing person, tasked with ensuring claims are filed in time to meet limitations, upon having a claim rejected by the relevant filing office, checks with someone else, who has no understanding of the process. In turn, the person checked with either provides a response that we are doomed, or, checks with another person who erroneously provides that response. I would have no hesitation in determining the responsible lawyer or firm to be grossly negligent in relying on such a system. It amounts to no system at all. It relies on luck to ensure that claims are filed in time.

This is likely the part of the judgement that will receive the greatest degree of scrutiny (notwithstanding the fact-specific nature of any gross negligence finding) simply because any finding of gross negligence will eviscerate the carefully constructed limitation on liability that the CAPL 1990 has created for the operator. So, is the analysis convincing? Is the limitations analogy appropriate? What is it that actually helps us draw the line between ordinary and gross

negligence? Has the Court offered any real guidance on this question or is it simply a case of "we know it when we see it"? And how large is the category of gross negligence?

I don't propose to try and answer all of those questions here but my sense is that the category of negligence is large and the two paragraphs quoted above come dangerously close to saying that the operator must get it right (even where questions of interpretation are involved) and that anything short of that is not just negligence but gross negligence. One way to think about it this is to ask what Hunt would have had to have done to avoid the label of gross negligence? It seems that Hunt needed to have in place a system for maintaining title for properties for which it is the operator that have the following characteristics: (1) the system must ensure that all applications for continuance are filed in a timely way, (2) the system must ensure that such an application meets the requirements of the regulations or if it fails to do so and the operator has a chance to supplement the application it needs to have in place a system that would generate a correct response, at least in an easy case. If this even comes close to capturing the standard of conduct expected of the operator by the court to avoid attracting the epithet "gross" then the umbrella of protection that the court has just re-affirmed in its interpretation of clause 401 seems very narrow.

Contributory Negligence

Because of the finding of fact made by the trial judge (that Hunt had not in fact delivered all the supporting material for the continuance application to its co-owners) Hunt was left to make the argument on appeal that A & S contributed to the loss themselves by failing to make sure that Hunt acted upon the opportunity to present additional evidence to the Department. The trial court had rejected that argument holding, in effect, that A & S were entitled to assume that Hunt would do its job and protect their interest. The Court of Appeal held (at para. 60) that there was no palpable and overriding error in this assessment of A & S's behaviour.

But I wonder if there is not a logical inconsistency here. If it really is the case that an operator is protected from liability for mere negligence, how can the joint operator ever simply be able to assume that the operator will act as a "good operator" (and see also para. 73) and protect its interest? There is something to be said for the idea that if the joint operator sees something going awry then it should take at least some minimal steps to ensure that the operator is put back on the straight and narrow.

The same result followed in relation to Hunt's efforts to have A & S contribute to the liability owed to Rana for loss of the royalty interest. That liability was *prima facie* a contract-based joint and several liability that Hunt should have been able to share. But the result here is that Hunt is effectively required to indemnify its partners with respect to this liability. Precisely how we get to that conclusion is less than clear. In the brief discussion (at para 75) there is the suggestion that the conclusion flows from the fact that the royalty agreement "was amended or altered" and had "imposed on it the terms of the JOA" including cl. 401 and its gross negligence exception.

The Fiduciary Duty Issue

Any fiduciary duty case in the context of the oil and gas operating agreement raises at least three separate questions: (1) is there a fiduciary duty, (2) what is the content of the duty, and (3) has the duty been breached.

As to the first question there is of course a lot of case law glibly asserting that the operator is a fiduciary for the joint operator. The cases include *Powermax v Argonauts* [2003] ABQB 4, *Great Northern Petroleums v Merland* (1984), 36 Alta. LR (2d) 97, and *Bank of Nova Scotia v Societe Generale,* [1988] 4 WWR 232. But the glibness is misleading. The operator is not one of the *per se* categories of fiduciaries like the trustee\ beneficiary and the agent\principal[1] so each case requires what Justice La Forest (dissenting on this point) referred to in *Lac v. Corona* [1989] 2 SCR 574 as an examination of the relevant facts and circumstances. That examination is informed by an assessment of the purpose of the fiduciary classification which is to protect vulnerable persons. But vulnerability alone is not enough. There must also be an assessment that it is reasonable to expect that the person to be classified as a fiduciary will put aside their self interest and act instead in the best interests of the fiduciary (or in the case of a partnership or a joint venture, that entity): *Hodgkinson v Simms*, [1994] 3 SCR 377. And it is this latter that is, and appropriately so, the principal stumbling block to imposing a fiduciary obligation in a commercial context since a duty of undivided loyalty owed to another is hardly the stuff of commercial relationships: *Luscar v Pembina* [1995] 2 WWR 153.

As for the content of the duty, the principal duty owed by a fiduciary is the duty of undivided loyalty, the duty to avoid even being placed in a position where (self) interest and duty conflict (*Keech v Sandford* (1726) 2 Eq. Cas. Abr. 741). But the fiduciary also owes a more general duty which is the duty to take that care of the asset (in relation to which it owes a fiduciary duty) that a reasonable person would take of their own property (*Fales v Canada Permanent Trust Co*, [1977] 2 SCR 302; *Blueberry River Indian Band v Canada* [1995] 4 SCR 344).

But there is a tendency to conflate the first two of these three questions and that seems to have happened here in both the trial judgement and that of the Court of Appeal. Justice Miller at trial concluded that Hunt owed and was in breach of a fiduciary duty to each of A & S and Rana with little more than a recitation of the well worn three-part test from *Frame v Smith*, [1987] 2 SCR 99. The Court of Appeal rightly castigated that as entirely inadequate and undeserving of any degree of deference (at para 66) but the Court's own conclusion for rejecting Justice Miller's conclusion might have been better reasoned. In effect the Court of Appeal found that there was no fiduciary duty here because Hunt's conduct was not willful and that the courts generally only impose a fiduciary duty where there is both vulnerability and "intentional conduct". In this context intentional conduct seems to be little more than a generalized reference to the issue of whether or not Hunt was in breach of a duty of undivided loyalty. But how did we get to that point? The first question should have been did Hunt owe a fiduciary duty? And while the Court found all three of the plaintiffs to be vulnerable (at para 73) the Court never inquired as to whether it was reasonable to think that Hunt would put aside its self interest. But in a sense that question was irrelevant because the facts of this case never raised an issue of self dealing. The party that suffered the most here from the failure to make a proper application was Hunt itself.

---

[1] But here of course there was de facto an agency relationship by virtue of both the language of 309 (act on behalf of the parties and for the joint account) and the designated representative requirement of the regulations. But even if that sufficed to make the operator a fiduciary in relation to this particular matter there was no breach of the duty to self deal; at most there was a failure to take adequate care which takes us back to negligence and the scope of the limitation on liability. Neither court refers to the law of co-ownership. But the starting point in a co-ownership situation is that there is no fiduciary duty as between the parties: Kennedy v. De Trafford[1897] AC 180 HL(E)). But as Kennedy recognizes, a co-owner may assume greater responsibilities if it agrees to act as a bailiff\property manager. The duties in relation to the title documents have some of these property management characteristics.

The only element of the fiduciary duty analysis that was ever going to have any bite was the general duty of care owed by a fiduciary which is perhaps why the Court should not have been so quick to conclude (at para 64) that clause 401 limiting the liability of the operator did not extend to breaches of fiduciary duties. Perhaps the Court's conclusion is obvious in relation to duties flowing from the undivided duty of loyalty; but it is less obviously so in relation to the fiduciary's duty of care.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

July 4, 2008

What Happens When the Deep Rights You Just Purchased are being Drained by the Vendor's Shallow Rights Well?

Written by: Nigel Bankes

Cases Commented On: *Nexxtep Resources Ltd v Talisman Energy*, 2007 ABQB 788, affirmed 2008 ABCA 246

What happens when a purchaser obtains the deep rights under certain oil and gas leases (along with a producing horizontal well) and the parties exclude another vertical well on the basis that it is producing from the shallow rights retained by the vendor and later the purchaser forms the view that the well is producing from the deep rights and not the shallow rights? That is the issue on the merits in *Nexxtep* – barring disagreements as to just where the vertical well was producing from. At present the case is reported only on certain preliminary matters, Nexxtep's request for an injunction and Talisman's request for summary judgment.

The Facts

Nexxtep purchased certain petroleum and natural gas rights under Crown oil and gas leases from the base of the Mannville through the Rock Creek formation to the base of the Pekisko pursuant to a purchase and sale agreement (PSA) of March 2004 with Talisman. The assets included a horizontal well but not a more prolific vertical well which, at the time of the PSA, both parties assumed to be producing from above the base of the Mannville. Subsequent investigations by Nexxtep established that the vertical well was producing from the Rock Creek formation below the Mannville. When Nexxtep's requests that Talisman shut in the vertical were unsuccessful, Nexxtep commenced this action as well as an application for an injunction requiring Talisman to shut in the vertical well below the Mannville. Talisman sought an order for summary judgment and in the alternative security for costs.

The Disposition by the Chambers Judge

Justice Colleen Kenny denied each of the applications for injunctive relief, summary judgement, and security for costs.

The application for summary judgment was denied because, while the affidavit evidence showed on the balance of probabilities that Nexxtep knew that it did not purchase the vertical well or any production from that well or pay for that asset, Nexxtep did believe that it was purchasing the Rock Creek formation and did not understand that the vertical well was producing from that formation.

The application for an injunction was denied because while there was a serious issue to be tried what Nexxtep sought was, in effect, a mandatory injunction for which it needed to be able to establish a strong prima facie case; it could not do so. Further there was no irreparable harm here. To the extent that Talisman was producing Nexxtep's gas this might be readily quantified

and damages payable. And, to the extent that Nexxtep sought to use the gas resources of the Rock Creek formation to assist in producing Pekisko gas, that was speculative and could not support an argument of irreparable harm. Neither did the balance of convenience support Nexxtep since Talisman's vertical well was more prolific and any enhanced production from Nexxtep horizontal well was speculative at best.

There was no evidence to support an application for security for costs. The only evidence before the court was that Nexxtep had purchased some $4 million of assets from Talisman.

Talisman appealed.

The Disposition on Appeal

The Court (Justice Constance Hunt, Justice Clifton O'Brien, and Justice Alan McLeod) dismissed the appeal.

Summary judgment will only be granted if it is plain and obvious that there is no genuine issue to be tried and the standard of review is reasonableness as to the decision and correctness as to the legal test. In this case there were factual issues as to whether the well was indeed producing from the Rock Creek formation and the effect of the EUB designation of the well as a Lower Mannville well at the time the PSA was signed. These were not matters that could be resolved on summary judgment and the trial judge applied the correct test.

Similarly, Talisman was not entitled to summary judgment on the basis of a rectification argument so as to have the PSA conform to what Talisman alleged to be the shared intentions of the parties, i.e. that the PSA should exclude the vertical well and its producing zone even if that well were draining hydrocarbons from a formation conveyed to Nexxtep. The evidence on this point was contradictory and the trial judge's decision was therefore not unreasonable.

Analysis and Comment

There seems to be nothing very remarkable about the disposition of any of these preliminary matters by either court. Manifestly this was not a case for summary judgment. There will be difficult technical issues here surrounding the classification of deep and shallow rights, the effect of EUB\ERCB zone designations and no doubt the construction of the PSA and the supposed common intention of the parties at the time the agreement was executed.

So the real interest in this case lies in the future disposition on the merits and we wait with bated breath! On the face of it, if Talisman's vertical well is indeed completed in a formation the rights to which were conveyed to Nexxtep, then that well is prima facie a trespassing well. On the other hand, if the well is completed in a formation to which Talisman has retained rights and the well

is simply draining from the deeper formation with which it is in communication, then, unless application of the rule of capture is precluded by operation of the contractual documents (*Anderson v Amoco Canada Oil and Gas*, [2004] 3 SCR 3 at paras 34 and 39), and provided that the well complies with any relevant spacing requirements (*Gulf Canada Resources Ltd v Ulster Petroleums Ltd*, [1998] 4 WWR 773 (Alta. CA)), Talisman's continued production of that well will fall within the no-liability aspect (*Anderson* at para 37) of the rule of capture.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

September 22, 2010

What's the Next Step when Shallow Rights Become Deep Rights?

Written by: Nigel Bankes

Cases Commented On: *Talisman Energy Inc v Energy Resources Conservation Board*, 2010 ABCA 258; ERCB Decision 2009-050, Nexxstep Resources Ltd., Pool Delineation Application: Redesignation of the Lower Mannville C Pool to Rock Creek, Wilson Creek Field, August 7, 2009; ERCB letter decision, June 23, 2010, unpublished, available here

The purpose of this note is to update readers on the developments in a set of facts that first came before the courts in 2007 and on which I blogged in July 2008.

The Facts

The facts, as outlined in my earlier blog, were as follows:

"Nexxtep purchased certain petroleum and natural gas rights under Crown oil and gas leases from the base of the Mannville through the Rock Creek formation to the base of the Pekisko pursuant to a purchase and sale agreement (PSA) of March 2004 with Talisman. The assets included a horizontal well but not a more prolific vertical well which, at the time of the PSA, both parties assumed to be producing from above the base of the Mannville. Subsequent investigations by Nexxtep established that the vertical well was producing from the Rock Creek formation below the Mannville. When Nexxtep's requests that Talisman shut in the vertical were unsuccessful, Nexxtep commenced an action [the QB action] and brought an application for an injunction requiring Talisman to shut in the vertical well below the Mannville. Talisman in turn sought an order for summary judgment and in the alternative security for costs."

That earlier blog commented on the decisions of both the Court of Queen's Bench and the Alberta Court of Appeal. In those decisions the two courts denied both the application for interlocutory injunctive relief and the motion for summary judgement. The substance of that action is still ongoing. Indeed, in the Court of Appeal decision under review in this comment Justice Bruce McDonald noted that:

> Counsel advised this Court that a Court of Queen's Bench Justice has granted an Order in the QB action to bifurcate the trial. As a result, the issue of the ownership of the 00/2-16 well will be tried initially and depending upon the result, the trial will then proceed to deal with other issues. It is anticipated that the first portion of the trial will take the better part of two weeks… (at para 5).

In addition to the QB action, Nexxtep also brought an application under s.33 of the *Oil and Gas Conservation Act*, RSA 2000, c. O-6 (*OGCA*) to have the Board redesignate the Wilson Creek Lower Mannville C pool (the C pool) as the Jurassic Rock Creek Formation and also to provide certain consequential relief under ss. 16 and 25 of the *OGCA*. Section 33 provides in part that:

> 33(1) The Board may, by order ….
>
> (d) designate any stratum or sequence of strata as a zone, either generally or in respect of any designated area or any specified well or wells.
>
> (2) If a dispute arises in the application of a pool or zone designation made by the Board, the dispute shall be referred to the Board and its decision on it is final.

At the time of the Nexxtep's application to the Board there were two wells producing from the C pool, the 00/2-16 well (producing from the A interval) and the 00/6-21 well. A third well, the horizontal 02/2-16 well that Nexxtep had purchased from Talisman, produced from the B interval.

In August 2009 Nexxtep obtained a majority decision from the ERCB (Decision 2009-050) agreeing to the redesignation. Much of that lengthy decision (48pp) is concerned with a detailed technical assessment of the evidence. From a legal perspective perhaps the key findings were these:

> (1) The onus of proof in such an application is proof on the balance of probabilities. The evidence must show that "the conclusion that the applicant seeks to establish is substantially the most probable of the possible views of the facts presented to the Board." (at 6) The Board rejected the argument that in a redesignation application a higher onus should be imposed on the applicant (on the grounds that settled expectations that had been built up around the existing designation and those expectations should not lightly be disturbed).
>
> (2) The 00/2-16 well and the 00/6-21 well were not in communication. The 00/2-16 well should be removed from the C pool and placed in a separate single well pool and designated as a Rock Creek well.
>
> (3) Redesignation did not itself resolve the question of whether the 00/2-16 well and production from the well was owned by Talisman or by Nexxtep. That would have to be resolved in the QB action. Given that conclusion the Board rejected Nexxtep's argument that Talisman's licence should be cancelled (on the basis that Talisman could no longer establish its entitlement to produce the well as required by s.16 of the OGCA) but it did suspend Talisman's licence pending resolution of the QB action.

Talisman applied under s.39 of the *Energy Resources Conservation Act*, RSA 2000, c. E- 10 to have the Board review its decision – both the decision to suspend and the decision to redesignate. In a letter decision dated June 23, 2010 the Board rejected that application concluding that Talisman had not demonstrated that the hearing panel made an error. The Review panel also refused to lift the licence suspension decision noting that "until the ownership of the Rock Creek in section 16 is resolved, whether by agreement or via litigation, Talisman does not meet the applicable requirements to produce the Rock Creek from the 00/2-16 well." (at p. 4).

And that takes us to the most recent development which is Justice Bruce McDonald's decision of September 9, 2010 to deny Talisman's application for leave to appeal the Board's decisions to the Court of Appeal. There is nothing particularly unusual about this decision. In large part, Talisman seems to have been trying to persuade the Court that the ERCB made the wrong decision – but that hardly raises a question of law or jurisdiction despite counsel's creative attempts to convince Justice McDonald otherwise.

So, as I said over two years ago, we wait with bated breath for the QB decision on the merits! And since the well continues to be suspended perhaps there is actually some incentive for the parties to get on with this matter and get it resolved.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

February 13, 2012

Deep Rights, Shallow Rights, and the Interpretation of a Purchase and Sale Agreement

Written by: Nigel Bankes

Case Commented On: *Nexxtep Resources Ltd v Talisman Energy Inc*, 2012 ABQB 62

The oil and gas industry splits petroleum and natural gas rights by substances to create severed estates in gas and petroleum but it also splits rights along the vertical axis into different formations. Split rights may be created along the vertical axis for several reasons. In some cases the Crown or other lessor initiates the severance in order to encourage exploration (e.g. deep and shallow rights reversions – explore non-producing horizons in your lease or lose them). In other cases rights will be severed as part of farmout agreements since farmors will be reluctant to allow the farmee to earn interests in formations that are deeper (and in some cases shallower) than those formations to which the test well is to be drilled. But these vertical splits cannot always be determined with accuracy and in some cases the Energy Resources Conservation (ERCB) may be asked to classify or reclassify whether a pool is part of deeper rights or shallower rights for the purposes of different conservation rules including, spacing rules, first well in the pool rules etc.: see *Oil and Gas Conservation Act*, RSA 2000, c O-6, s 33.

The uncertainties (and changing classifications) associated with vertical splits may also have implications for private agreements such as the purchase and sale agreement (PSA) between Talisman (the vendor) and Nexxtep (the purchaser) at issue in this particular case. In this case Nexxtep argued that Talisman was producing from an asset that Talisman had transferred to Nexxtep and as a result sought damages in trespass.

I have blogged decisions on this fact pattern on two previous occasions. The first blog discusses a decision of Justice Kenny 2007 ABQB 788 (and the appeal 2008 ABCA 246) in which the court refused Nexxtep's application for an injunction to prevent Talisman from producing, and declined as well Talisman's application for summary judgement. The second blog discusses Nexxtep's successful application to the ERCB to have it redesignate the vertical well that was at issue in this case (ERCB Decision 2009-050) and Talisman's unsuccessful application to obtain leave to appeal that decision: 2010 ABCA 258. The effect of this decision was to shut-in the vertical well pending resolution of the ownership issue – this decision.

This post focuses on Justice Poelman's decision on the merits in relation to a set of preliminary issues that Justice Kenny set down for trial: 2010 ABQB 452. These issues were principally two, first, did Nexxtep acquire any rights to production from the vertical well under the terms of the PSA, as properly interpreted, and second, assuming it did, should the terms of the PSA be rectified to restore these rights to Talisman? As it happens, Justice Poelman dealt with a third issue since he went on to consider Nexxtep's damages claim on the assumption that Nexxtep was entitled to succeed on the first two issues.

Under the terms of the PSA, Talisman agreed to sell to Nexxtep certain "Assets" in the Leedale area of Alberta for $3.95 million. The Assets included petroleum and natural gas (PNG) rights defined as being under a certain surface location and within the "base of Mannville to base of Pekisko" zone plus their associated "Tangibles" (equipment for production, transportation and processing) and "Miscellaneous Interests" (property, contractual rights, records and data relating to the PNG rights and tangibles).

Evidence as to the "genesis of the transaction" showed that Talisman had a number of assets in the area and was only prepared to sell some of them as part of this transaction. Talisman and Nexxtep agreed to divide the assets on the basis of who operated the assets and the related infrastructure (Talisman or Calpine, a co-owner of some of the assets). In particular it was clear that both parties understood that there were two wells producing from below the designated surface location: a vertical well believed by both parties to be producing sweet gas from within the base of the Cardium to the base of the Mannville, and a horizontal well producing sour gas from a formation that was within the lower "base of Mannville to base of Pekisko" (at para 2).

Included in "Tangibles" was Talisman's interest in the horizontal well operated by Calpine but not the vertical well operated by Talisman. The two wells had separate transportation and associated processing infrastructure. Two years after closing, Nexxtep concluded that the vertical well was producing from a pool below the base of the Mannville and within the "base of Mannville to base of Pekisko" zone. After a contested hearing, the ERCB agreed with Nexxtep and redesignated the pool from which the vertical well was producing as being below the base of the Mannville zone.

Justice Poelman in a well crafted judgement emphasised that the job of the court is (at paras 5 – 6) "to ascertain what the parties objectively intended by their bargain, when they made it. Primacy is given to the parties' words, particularly in a written contract, because it is presumed that the parties chose words that embodied their intentions. However, the objective remains the determination of the parties' intention, not the meaning of words in a document." And in this case, Justice Poelman's examination of the terms of the PSA within a factual matrix in which Nexxtep knew it was buying certain assets in the land but not others allowed him to conclude (at para 59) that Nexxtep was purchasing Talisman's entire interest in the section 16 lands below the base of the Mannville but excluding the pool from which the vertical well produced.

In the alternative, if the contractual intentions of the parties remained unclear after taking into account the factual matrix, the resulting and continuing ambiguity could be resolved by taking into account evidence of subsequent conduct. That conduct included repeated efforts by Nexxtep to purchase the vertical well. This showed (at para 62) that for two years "both parties believed that the rights purchased by Nexxtep did not include any ownership in the vertical well or the pool from which it produced."

In the further alternative, Justice Poelman was of the view that this was one of those rare cases in which the court should order rectification if necessary to make sure that the written agreement conformed to the mutual intentions of the parties (at para 68):

> The findings I made above with respect to the factual matrix and parol evidence resolving ambiguity lead me as well to the conclusion that the mutual contractual intention of Talisman and Nexxtep was to convey Talisman's entire 34.4262% working interest in the petroleum and natural gas rights in Section 16 below the base of the Mannville zone, but excluding the pool from which the vertical well produced. If the principles of contractual interpretation do not permit the PSA to be interpreted at law to achieve that result, then there must be an order in equity rectifying the document in accordance with the aforesaid words.

Justice Poelman also went on to consider what would happen if Talisman did not succeed on either its interpretation or its rectification arguments. In that case the parties seemed agreed that Talisman's continuing production of the vertical well would be tortious and likely trespass – although Justice Poelman hinted that he preferred to characterize the taking as conversion. But how then should damages be measured? Justice Poelman reached the following conclusions. First, damages should be measured on a compensatory rather than a restitutionary basis (at paras 71 – 80). Second, damages should be assessed as of the date of the PSA and not as of the date of the Board re-designation order. This is because the Board's redesignation order might be conclusive in relation to matters covered by the *OGCA* but it is not conclusive with respect to the interpretation of the contract (at para 82). And fault is not a precondition to a successful action in trespass (nor conversion one might add). Third, compensatory damages should be calculated on the basis of net revenues that would have been received minus reasonable deductions for operating costs including reasonable equalization payments for the capital costs of the existing vertical well. It should be noted that the decision to apply the compensatory test of assessing damages (i.e. to put Nexxtep in the same position that it would have been in but for Talisman's tortious act) rather than a restitution approach (disgorge gains minus costs) is not as contentious in this context as it is in the context of a lessee producing on a dead lease. In a lease case the principal competing characterizations are between: (1) damages based upon the royalty that would have been payable had there been a lease (the 'mild' compensatory approach), and (2) the value of production minus operating costs. Where, as here, the contest is between working interest parties with competing ownership claims there will likely be little difference whether damages are calculated on a restitutionary or compensatory basis – although it could be different if Talisman's conduct fell to be characterized as reprehensible (argued by Nexxtep but rejected here) since the argument would then be that in such a situation the tortfeasor should not be able to deduct from its disgorgement its reasonable costs in recovering, processing and selling the production.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

Deep Rights, Shallow Rights, and the Interpretation of a Purchase and Sale Agreement

Comments:

Nigel Bankes says:

February 4, 2013 at 10:00am

> The Court of Appeal has confirmed Justice Poelman decision: 2013 ABCA 40, http://www.canlii.org/en/ab/abca/doc/2013/2013abca40/2013abca40.html. In doing so the Court seems to have placed significant weight on the background matrix which established not only what Nexxtep believed it was buying but also what it was not buying.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

July 17, 2008

What Happens When Parties Operate an Oil Battery Without a Formal Agreement?

Written by: Nigel Bankes and Iwan Saunders

Case Commented On: *Husky Oil Operations Limited v Gulf Canada Resources Limited*, 2008 ABQB 390

Husky Oil has complicated facts, some complex law (unjust enrichment, fiduciary obligation, rectification) and a confusing judgment, but surely only one possible result. Indeed, we wonder why it ever went to court at all.

Husky (63%), Gulf (20%) and Sabre (14%) (as well as two other parties who were not involved in the litigation) were co-owners of the Killarney Oil Battery. The battery was originally constructed to service wells that were co-owned by the five parties in the same percentages, but later the battery provided service: (1) to wells owned by the same parties (or some of them) but as to different interests (unequal ownership wells); and (2) to wells in which none of the battery owners had an interest (outside wells). The parties never executed a Construction, Ownership and Operation (CO & O) Agreement although two drafts of such an agreement were circulated (at para 5(2)). As a matter of practice, Husky acted as the operator of the battery for the co-owners and established and collected fees (subject to objections from time to time which objections were resolved through discussion and adjustments, at paras 3, 71). The battery was operated on this informal basis for some 15 years. In 1996, Husky tied in six wells, of which five were 100% owned by Husky and the sixth 97% owned. In response to an inquiry from Sabre as to the processing fees that were to be charged to these wells, Husky wrote that the well owners would be charged fees, retroactive to the date of tie-in, of $5.50/m3Total Fluid and 2.50/m3 salt water disposal, with the fees allocated to the Killarney battery joint account. The evidence showed that this was the fee that was typically charged to production from trucked-in wells.

Some three years later Husky took the view that it had been seriously overcharging for these wells and proposed to make a retroactive adjustment, with new fees to be based on some version of the Jumping Pound Formula. Discussions and correspondence followed. Sabre never agreed to the adjustment, and while Gulf signed off on one version of the proposal, other versions followed. Gulf's agreement was based on the impression that the adjustments would result in a credit and not a liability. Husky invoiced Gulf and Sabre based on its proposed adjustment, but both parties refused to pay.

Husky commenced this action claiming to be entitled to the invoiced sums on the basis of either unjust enrichment or rectification (at para 5(17)). There was no claim for a quantum meruit and neither party led evidence tending to show a custom in the industry as to the basis for charging fees for unequal ownership wells (at paras 8 & 35).

The Holding

Justice Rosemary Nation dismissed Husky's claims. With reference to unjust enrichment, she concluded that Gulf and Sabre were enriched and that Husky suffered a net deprivation (at para. 36) as a result of the manner in which it had established fees for the six wells. Those fees were the equivalent of trucked-in fees which were higher than those generally expected for tied-in unequal ownership wells (at paras 33-36). However, there were two juristic reasons for concluding that the enrichment in this case was not unjust. First, the relationship between Husky and the other joint battery owners had fiduciary components (at para 15) and yet, in its dealings with the co-owners in relation to the adjustments, Husky had failed to make full disclosure (at paras 42-45) both as to the manner in which the fees were to be calculated and as to whether the adjustment would result in a credit or a liability. This was a breach of Husky's fiduciary duty to act in the interests of all owners and not just in its interest as one of the joint owners (at paras 47, 15). As a result Husky was not entitled to the benefit of the "equitable remedy" of unjust enrichment (at para 47). Second, there was in fact a contract to charge fees at the $5.50/2.50/m3 rate based on Husky's written statement in 1996 and the silence and acquiescence of the other co-owners of the facility (at para 53). A contract constitutes a juristic reason for an enrichment (at para 48).

Assuming that there was a contract based on the $5.50/2.50 rate, Husky had not made out a case for rectification to set fees on the basis of a modified Jumping Pound Formula. There was no convincing proof that the parties in 1996 were *ad idem* that charges such as those circulated in 2000 and based on the Jumping Pound Formula were intended to apply to these six wells (at paras 56-57).

Nor did Gulf and Sabre contractually agree to a retroactive change in the fees. Although Gulf did appear to accept one version of the proposed new fees, Sabre never did. Accordingly there could be no new contract since this was a case of a joint contract (at para 68) which would set the processing fees for all joint battery owners and could only be concluded if all parties accepted. Husky could not unilaterally impose a mode of acceptance which involved incorporating a deadline in a letter and deeming failure to respond as deemed acceptance. The parties had no contract setting up such an arrangement and such a mode of proceeding was not consistent with the actual practice of the parties. In any event, Husky's continuing negotiations with Sabre and subsequent changes in the rates after Gulf had signaled its agreement, established that there was no clear agreement of all of the battery owners to one rate (at paras 71-72).

Analysis and Comment

The legal relationships between the parties involved in this litigation were undoubtedly complex. And they were rendered more complex by the failure of the co-owners of the battery to enter into a formal agreement appointing one of their number as operator and setting out the basis on which the co-owned facility would provide services, both to the owners and to non-owners. But Husky stepped into the breach and acted as an operator, and held itself out as the agent for the co-owners of the facility in their dealings with others, including, where necessary, dealing with itself as a potential and actual user of the jointly owned facility. Part of its assumed responsibilities included establishing, at least on a tentative basis, the rates that would be charged different categories of users. The rates were tentative in the sense that they would prevail unless one of the co-owners objected (at paras 3 & 64). In establishing those rates Husky no doubt had certain objectives in mind. In particular, it would want to make sure that receipts from rates were sufficient to cover the revenue requirements of the battery. Moreover, if it chose to charge

different rates to different classes of users, it could do so (given that Husky was neither a public utility nor a common processor), provided the market could bear the charge and its co-owners did not object to its tentative proposals.

One result of this is that one class of users might contribute more than its fair share of the costs (in utility parlance, cross-subsidize the other categories of users). And that seems to have been the nub of Husky's contention here. But note how Husky had to frame the case. Essentially Husky has to argue that it was required in its capacity as a user of the facility (rather than in its capacity as co-owner or as *de facto* operator) to over-contribute to the costs of the facility and that it was required to do as a result of a decision made by itself as *de facto* operator. In effect Husky, the well-owner, is trying to reach a result which might obtain were Husky, the operator, in a regulated utility, obliged to offer the service to all-comers on a non-discriminatory, cost-of-service basis. But in fact that was not the position here.

So what could Husky resort to? Well, the most obvious approach was probably the rectification argument, but there was just one snag. The facts simply did not support rectification. Where was the common understanding of what the rates should have been other than the rates that Husky actually charged (itself)? Justice Nation was quite right to summarily dismiss this clutching-at-straws argument.

That left Husky with its cause of action in unjust enrichment or, as Justice Nation would have it, the "equitable remedy" of unjust enrichment (at para 37). And this is where it seems to us that Justice Nation makes extraordinarily heavy going of what should have been a fairly simple case. The superficial explanation for this lies in the manner in which Justice Nation organizes her judgment. After reciting the facts, she turns to the relationship between the parties and characterizes it as fiduciary, concluding that Husky has breached its fiduciary obligation and is therefore disentitled to an action for unjust enrichment. Only later does she consider the possibility that the basic relationship is contractual, and that it is the contract which provides the essential juristic reason for the apparent enrichment that Gulf and Sabre had enjoyed at Husky's apparent expense. But the deeper explanation for the heavy going seems to be a misunderstanding of the nature and requirements of the action for unjust enrichment.

As mentioned, on a number of occasions Justice Nation refers to the "equitable remedy" of unjust enrichment. But first of all, unjust enrichment is not a remedy, it is a cause of action, just like tort and breach of contract are causes of action. Assuming a successful action, the remedy for unjust enrichment is restitution, just like compensatory damages is the primary remedy for tort and contract. Secondly, it is mistaken and misleading to speak of unjust enrichment as an "equitable" action. The roots of unjust enrichment lie deep in the common law, not in Equity and the Court of Chancery. Although certain equitable concepts, such as constructive trust, play a role in the modern law, this cannot detract from unjust enrichment's fundamental nature as an action at common law rather than in Equity. Neither is unjust enrichment "equitable" in the more colloquial sense of being a subject for broad judicial discretion. Like any other area of the law, unjust enrichment largely depends on evolving legal principle and available precedent, and trial judges and their decisions are governed accordingly. (See further on all this, M. McInnes, "The Equitable Action in Unjust Enrichment: Ambiguity and Error" (2007), *Can. Bus. L. J.* 253.) Thirdly, the structure of the action for unjust enrichment is currently set out in *Garland v. Consumers' Gas Co.* (2004), 237 DLR (4th) 385 (SCC). The onus initially rests with the plaintiff to establish a prima facie case, by showing that the defendant was enriched, that the plaintiff suffered a corresponding deprivation, and that there is no juristic (lawful) reason why the defendant should retain the enrichment. Garland then prescribes the recognized categories of

juristic reason, including contract. The plaintiff having established a prima facie case, the onus shifts to the defendant to rebut it on the basis of the "reasonable expectation of the parties" and "public policy", or any of the standard defences such as change of position. In accordance with the Garland structure, this is why we suggest that Justice Nation should have considered contract first, rather than fiduciary obligation, which should have been discussed later, if at all.

Assuming defendant enrichment and plaintiff corresponding deprivation, focusing immediately on the contractual analysis serves to reveal Husky's enormous difficulty. Surely it was obvious that there was a valid contract here. How else (absent a utility/customer relationship) can we explain this decade-long commercial relationship? While there was no executed CO & O Agreement to point to, there was, as Justice Nation, almost reluctantly, concedes, a pattern of behaviour that was completely consistent with a contract; an arrangement in which Husky proposed terms, those terms were reviewed by their co-owners (and no doubt others proposing to use the service offered by the battery) and in the absence of any objection those terms prevailed unless and until Husky proposed to alter them. In the end, then, the unjust enrichment argument clearly fails on the basis of contract as a juristic reason, a contract that was entirely of Husky's own making. No doubt this was all a bit messy, and one might have to resort to ideas of reasonableness and good faith in (re)constructing the contractual terms, but there are plenty of examples of courts using such interpretive tools to construct the terms of contracts in oil and gas cases even where there is a written contract: consider for example *Mesa v Amoco* (1994), 19 Alta. L.R. (3d) 38 (CA) (the part of the decision requiring reserves-based pooling); *Erehwon Exploration Limited v Northstar Energy Corp* (1993), 15 Alta. L R. (3d) 200 (the part of the decision (at para 155) dealing with reasonable notice to change the terms and conditions for marketing the plaintiff's gas) and *Kaiser Francis Oil Co of Canada v Bearspaw Petroleum Ltd* (1999) ABQB 128.

But we think there are other difficulties with the unjust enrichment argument. First, the nature of the alleged enrichment. After all, it's not as if Husky as well-operator was paying anything directly to Gulf or Sabre. Husky was actually paying Husky as agent for all of the co-owners. So what was the benefit to Gulf and Sabre? Justice Nation never really tells us (see para 36 for her conclusions) and so we have to guess a bit along the lines of the ideas outlined above. Presumably the benefit was either: (1) that the rates that were charged to other users (and note that this class might be much larger than just Gulf and Sabre) was lower than it might otherwise be; or, (2) that Husky actually received in total, from all of the clients of the battery, amounts in excess of revenue requirements (however defined, including, for example, a return on actual or deemed equity as would be provided for by the application of the Jumping Pound formula) and returned a share of this "profit" to the co-owners including Gulf and Sabre. The point is simply that the enrichment is much more indirect and not quite as obvious as Justice Nation seems to suggest in her judgment. Certainly the precise quantum of any enrichment was highly debatable.

And what of the fiduciary duty analysis here? Apart from the continuing over-emphasis on vulnerability rather than when is it reasonable for parties in a commercial setting to have an expectation of loyalty (*Hodgkinson v Simms*, [1994]. 3 S.C.R. 377), we think that Justice Nation formulated the test (or her conclusions) in an appropriate way when she says (at para 15) that "Husky had obligations to act in the interests of all owners, not just its interest as one of the joint owners." And why was it appropriate to find a fiduciary duty here? Well, at least in part because

the contractual relationship was so rudimentary. The very basis on which Husky set rates (when it had a monopoly on the relevant information because of its position as de facto operator) suggested not only vulnerability but also that it was reasonable for the non-operator co-owners to conclude that Husky would act in the best interests of all of the co-owners rather than in its own best interests.

As a fiduciary, Husky owed a duty of full disclosure as to the basis of the rate calculations as well as a duty not to self-deal. Processing your own gas at a discounted rate without disclosure might well be self-dealing, but in this case there was no suggestion that Husky had given itself preferential treatment. This only became an issue when Husky attempted to unravel the existing arrangement, and at that not simply on a go-forward basis. At that point the failure to disclose did become material. Nevertheless, while there are cases where the court declines or adjusts an equitable remedy to ensure that the court is not party to an inequity (one thinks for example of *Lac Minerals Ltd. v International Corona Resources Ltd.*, [1989] 2 SCR 574, and the conditions placed on the court's declaration of a constructive trust), it seems unnecessary and inappropriate to invoke that line of reasoning here, for two main reasons. First, there was a much simpler way of proceeding and that was to invoke the existence of a contract between the parties. And second, in using this line of reasoning Justice Nation incorrectly characterizes the cause of action in unjust enrichment as an equitable remedy, thereby confounding cause of action and remedy as well as lumping equity and unjust enrichment together, rather than recognizing unjust enrichment as a discrete source of obligation.

Finally, if we are right in saying that there was clearly a valid and subsisting contract between the parties, and clearly no basis for rectification, why did this case ever end up in the courtroom at all?

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

August 14, 2008

When Does a Royalty Owner not have to Pay for a Share of Processing Costs?

Written by: Nigel Bankes

Case Commented On: *574095 Alberta Ltd v Hamilton Brothers Exploration Company*, 2008 ABQB 413

When does a royalty owner not have to pay for a share of processing costs? The answer of course should be that the royalty owner does not have to pay unless it is required to do so by the terms of the agreement that created the royalty. And that in fact is exactly what Justice Alan Macleod concludes in this judgement. Just as there is no rule of law that precludes an oil and gas lease from being kept in force beyond the end of its primary term by the mere existence of a shut-in well in "accordance with oil field practice" (see *Kensington Energy Ltd v. B & G Energy Ltd* 2008 ABCA 151 and my post on this decision), so too there is no rule of law that requires a royalty owner to pay a share of post-severance processing costs. This judgement confirms that processing costs are issues of contract between the parties and that the job of the court is to give effect to the terms of the agreement that the parties have negotiated.

The Facts

The Hamilton Brothers Exploration Company (HBEC) disposed of all of its oil and gas assets in Alberta in 1979. For tax reasons the sale was structured in such a way that the most significant part of the purchase price was paid by way of a gross overriding royalty reserved by HBEC which terminates only when total receipts equal $490.5 million. Over the years there has been considerable litigation on various aspects of this agreement. I have commented on many aspects of that litigation in Bankes, "Private Royalty Issues: A Canadian Viewpoint", *Private Oil and Gas Royalties*, Paper No. 8, pp. 1- 65, Rocky Mountain Mineral Law Foundation, 2003.

Under the agreement (cl. 2(a)) the royalty is payable on "the value of all petroleum substances produced from and/or allocated to" the Assets and calculated after the deduction of certain defined "burdens" (which all parties agreed did not cover processing costs). Sales of petroleum substances were to include the royalty share and the agreement defined (cl. 2(c)) "value" as "the full price paid by a bona fide purchaser (including any credit taken by such purchaser by virtue of any prior "take or pay" payment) at the point of sale of the petroleum substances produced, saved and marketed from, or allocated to, the wells located on the said lands excepting the amount of the burdens".

In addition to the purchase and sale agreement there were other agreements between the parties including the disbursing agreement which reiterated that the purchaser was to "pay all costs and expenses incurred in connection with the Said Assets covered by the conveyance, excluding payment of the burdens and the payment of the rentals". The disbursing agreement prescribed how certain calculations and allocations were to be made but said nothing on the subject of gas processing costs.

The practice of the parties was not to deduct gas processing costs from the royalty account and the issue was not raised until the mid-1990s. This litigation commenced in 2000 and, pursuant to an order of court, $25,000 per month was withheld from disbursement to HBEC.

The Judgement

Justice Alan Macleod dismissed the plaintiff's claim. In his view (at para 23) "royalty is a creature of contract", the parties are free to enter into any arrangement and the issue is "what does the contract in this case say"? And the crucial issue was to ascertain the point at which value was to be calculated. Was it at the point of sale or the point of severance (id)? And in answering that question the Court was entitled to consider not only the agreements themselves but also the surrounding circumstances and the conduct of the parties in implementing the agreement. Review of all of this material led Justice Macleod to conclude that this was not an ordinary transaction but was unique; Hamilton itself had invested its capital in the construction of a gas processing plant and this plant was included in the sale of the assets. With that as background the words used were clear. The royalty agreement (at para 32) "calls for the payment of the royalty on the full price paid at the point of sale excepting the amount of the burdens. Other than the burdens [the purchaser] covenants to pay all costs and expenses incurred in connection with the assets which include the oil and gas interests and gas processing and gathering infrastructure." Furthermore (at para 33), had the parties agreed that processing costs were deductible "it is simply not conceivable … that the agreements would not have contained precise instructions as to how that calculations should be made." It was well known within the industry that the point or place that value is to be determined is a crucial feature of any royalty agreement and by defining value in terms of the point of sale the parties "deliberately decided to exclude processing costs upstream from the point of sale" as legitimate deductions.

Assessment

In light of the express language of this agreement one can only assume that the plaintiffs felt the need to litigate this matter because of their mistaken belief that there was some sort of rule of law in Alberta that requires a royalty owner to pay for its share of post-severance costs. This is not the case and hopefully Justice Macleod's judgement will settle this point once and for all. To be sure it is common practice to structure agreements so as to require that royalty liability is to be calculated at the point of severance (i.e. at the wellhead) thereby requiring the royalty owner to pay its share of any costs incurred adding value to the resource (e.g. pipelining and processing costs) from that point forward to the points of sale. And, to be sure, this practice makes commercial sense. After all, why should a royalty owner be entitled to the benefit of the value added by the working interest owner post-production, and why should the royalty vary depending upon whether the first point of sale is downstream of the processing plant in Alberta or to a co-generation plant in New York? But these are all reasons for careful drafting; they are not reasons for creating a rule of law that should trump the intentions of the parties as revealed in the language of the contract.

If one looks at the existing case law the only decision that really offers much support for the plaintiff's contention is Justice Power's decision in *Resman Holdings Ltd v. Huntex Ltd et al* (1984), 54 A.R. 281 (Q.B.) but I think that that decision is unreliable because the court never really addressed its mind to the crucial question which was: where was the "outlet valve to the pipeline" as those words were used in the agreement?

While Justice Macleod's judgement should settle these issues and the approach to be taken to the construction of royalty agreements, some may read his judgement as having left the door slightly ajar insofar as he emphasises that this transaction was unique (at para 32) and not a "typical" (at para 29) transaction. And while he concludes (at para 29) that he should not superimpose the features of the typical transaction on this particular transaction, he immediately qualifies this by saying "unless there are compelling reasons to do so". But what would those compelling reasons be?

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

October 9, 2008

When Does a "Participant" Earn Under the Terms of a Farmout and Participation Agreement?

Written by: Nigel Bankes

Case Commented On: *Solara Exploration Ltd v Richmount Petroleum Ltd*, 2008 ABQB 596

In this decision Justice Sheilah Martin concluded that a participant in a farmout and participation agreement did not earn an interest in the farmout property when it elected to go non-consent on an operation to frac a particular formation, even when that operation was proposed after the parties had already installed a well head, outlet valve and production tubing. However, Justice Martin went on to hold that the farmor was estopped from denying that the participant had earned in the circumstances of the particular case. The decision is an important one for several reasons. It is a first decision on the definition of "completion" in the 1990 CAPL operating procedure, but it also serves to draw attention to the vulnerability of a "participant" in a farmout and participation agreement, especially where the farmor (as here) is wearing multiple hats and serving as both farmor and as operator for the purposes of the test well to which the participant is contributing. The case also highlights some of the difficulties associated with borrowing definitions from other agreements.

Facts

Richmount, Twin Peaks and RMU, who together held a 100% interest in the farmout lands, entered into a farmout and participation (F & P) agreement with Dyno as the predecessor in title to Solara. Attached to the head agreement were the 1997 CAPL farmout and royalty procedure and the 1990 CAPL operating procedure. Under the terms of the F & P agreement, Dyno was to earn a 25% share of Richmount's interest in the farmout lands before payout (BPO) (subject to a gross overriding royalty) diluted to a 17.5% interest after payout. During negotiations towards the agreement Dyno agreed to pay an amount for land equalization costs in return for a larger working interest share.

Under the terms of the farmout agreement Dyno was to earn when the test well was completed, capped or abandoned, but it was Richmount as operator that was to "drill to Contract Depth, test, complete, cap or abandon the Test Well". Drilling proceeded on the basis of an authorization for expenditure (AFE # 1) provided by Richmount. Dyno paid its 25% share of those costs. AFE # 1 called for directional drilling of the test well to a Basal Quartz target along with placement and cementing of production casing and logging. Richmount drilled the well to Contract Depth, logged the well and ran production casing. The rig was released.

Richmount then sent out AFE # 2 describing a completion program to complete and test the Basal Quartz and the Mannville. Richmount described the program as a "Completion/Workover/Re-entry" and assigned tangible costs for Production Tubing and Accessories and Wellhead and Installation and Related Equipment. Dyno paid its share of the

expenses and the work was completed. In particular, a wellhead and outlet valve were installed at the well location, the Basal Quartz formation was perforated and production tests run.

As a result of the production tests it was understood that it was not economic to tie-in the well for production, whereupon Richmount proposed a fracing operating and sent out AFE # 3 to that effect. Richmount described the operation variously as a "workover" and a "completion\workover" and proposed fracing the Mannville and installation of further production tubing for that purpose. Dyno communicated its decision not to participate by letter in which it indicated that while the operation was not proposed as an independent operation it was prepared to deem it to be such under cl. 1008 of CAPL. Dyno further noted that it expected to be subject to a 300% penalty for the workover operation and a 200% penalty with respect to equipping costs. Dyno did not send a formal "earning letter" asserting that it had earned its interest and seeking a formal transfer of that interest.

The operation proceeded and the well was ultimately placed on production. While Richmount took the view that the result of Dyno's non-participation was that Dyno had not earned, Richmount did not communicate this understanding to Dyno for some five months. During this time and because of this understanding Richmount failed to offer Dyno the opportunity to participate in a second well that was drilled on the farmout property which well also went into production.

Dyno\Solara argued in this action that: (1) the well was completed on the basis of AFEs # 1 and # 2, and, in the alternative, (2) Dyno was entitled to an interest by virtue of Richmount's breach of the agreement, or (3) Richmount was estopped from denying that the Test Well was completed and that Dyno had earned. The F & P Agreement incorporated various definitions from the CAPL operating procedure including the definition of completion:

> "Completion" means the installation in, on, or with respect to a well of all such production casing, tubing and wellhead equipment and all such other equipment and material necessary for the permanent preparation of the well for the taking of petroleum substances therefrom up to and including the outlet valve on the wellhead and includes, as necessary, the perforating, stimulating, treating, fracing and swabbing of the well and the conduct of such production tests with respect to such well as are reasonably required to establish the initial producibility of the well.

Decision

Justice Sheilah Martin held that Richmount was estopped from denying that Dyno had earned an interest in the test well.

The definition of completion has three aspects: (1) installation of all equipment necessary for taking production on a permanent basis, (2) completion may require fracing etc, and (3) tests necessary to establish initial producibility. Dyno was not able to show, on the balance of probabilities, that all necessary equipment had been installed under the first branch of the definition. With respect to the second aspect of the definition, not all fracing operations are included within the definition of completion; this will depend on the circumstances. Fracing may occur after completion in which case it is sometimes (but not always) referred to as a workover. The evidence here tended to show that in this case fracing was necessary for completion.

Richmount was estopped from denying that Dyno had earned. Richmount was aware of Dyno's position that it had earned; the fact that Dyno did not send a specific "earning letter" was not relevant. In these circumstances (where Richmount was both farmor and operator for the farmee), Richmount's silence amounted to a representation intended to induce a course of conduct. Richmount had a duty to respond to Dyno's assertion and had a duty to communicate clearly as to the categorization of proposed operations. Richmount used different labels (completion and workover) to describe the activities covered by AFE # 3 which invited confusion as to whether the operations covered by the AFE were part of completion or post-completion. In the industry, the term "workover" is generally confined to an operation that occurs post-completion and ordinarily after the well has been placed on production. In these circumstances it would have been better for Richmount to have described AFE # 3 as a "supplementary completion AFE". Dyno relied on the representation in the sense that had it been aware of the fact that Richmount was taking a different position it would have contributed its 25% share of the costs ($40,000) to maintain an interest rather than sacrifice the $200,000 it had already disbursed.

This was not a case (such as *Canadian Superior Oil v Paddon-Hughes Development Co Ltd* (the *Hambly* case) [1970] SCR 392) where estoppel was being used to revive a terminated agreement. Estoppel cases dealing with the lease were distinguishable. The evidence did not support Richmount's claim that Dyno was being strategic in its drafting of the letter.

On the balance of probabilities Dyno would have participated in the second well and thus it must be taken to have earned an interest in the second well in addition to the test well but must contribute at the penalty rate.

Assessment

I will comment on two aspects of this decision, first the vulnerability of the participant in arrangement of this sort and second, the court's treatment of the plaintiff's claims with respect to the option well.

Participation Agreements and the Vulnerability of Participants

In a pure farmout agreement the allocation of risk is usually fairly straightforward since the agreement will typically provide that the earning operation is to be conducted at the sole cost, risk and expense of the farmee. The farmee also has a duty to indemnify and hold harmless the farmor from any damages or expenses that the farmor might incur as a result of the operation. Similarly, in a pure farmout, the farmee will typically be in a good position to determine whether or not it has earned. The earnings rules will be spelled out in the agreement and ordinarily the farmee will be in charge of the operation. This is exactly what one would expect; a farmee likely does not want to give somebody else control of an operation that is being carried out at the farmee's sole cost, risk and expense. The penalty for failing to complete the earning operation is severe; the farmee will not earn and will thus have nothing to show for the expenditures made. Technically there is no forfeiture since the farmee has nothing until it has earned, but the consequences are similarly penal. Analytically, a farmout agreement is similar to an option and if the option analogy holds (as it certainly does in the context of mining agreements) then it follows that the farmee must comply strictly with all of the earning terms. Where there is only one party farming in there will be no need for an operating agreement until the farmee has earned its interest and there is a co-ownership situation (*Novalta v Ortynsky* [1994] 6 WWR 484 (Alta.

QB)), and for the same reason there will be no need for an authorization for expenditure to authorize and govern the operation.

The rules are also fairly clear when we are dealing with operations solely under the terms of an operating agreement. In such a case, all operations are conducted for the joint risk of the joint account unless they are conducted as an independent operation in which event that operation will be conducted for the sole cost, risk and expense of those parties participating in the independent operation. Operations for the joint account above a certain amount always require an AFE. Subject to some difficulties with the 1981 version of the CAPL agreement (see *Morrison Petroleums Ltd v Phoenix Canada Oil Co* (1997), 198 AR 81 (QB)), a party who executes an AFE signs on to the full cost of that operation even if the operation exceeds projected costs (*Renaissance Resources Ltd v Metalore Resources Ltd* [1985] 4 WWR 673 (Alta. C.A.)). But a drilling AFE is only a commitment to participate to the "casing point election". A second AFE is always required to commit the parties to completion and it follows that in a situation where a party elects not to complete at that point it is going non-consent and thus is to be treated as an independent operation with the non-consenting party subject to a penalty. The consequences of failing to execute an AFE or failing to contribute the full costs associated with an AFE are not as severe as are the consequences of failing to earn in a farmout. With the exception of title preserving wells (TPW), a party who fails to sign on to independent operation AFE is consigned to a penalty position; it does not (except in the case of a TPW) suffer forfeiture. A party who fails to pay assessed contributions is simply in breach of the operating agreement and the agreement provides a whole suite of remedies (Article V) to the operator for that eventuality.

If these things are reasonably clear in the context of pure farmout agreements and operations pursuant to an operating agreement, they soon become fuzzy when other elements and concepts are introduced such as the concept of "participation" as in the present case. This is not the first case in which earning has been contentious in the context of a participation agreement: see for example *Hi-Ridge Resources Limited v Noble Mines and Oils Ltd*, [1978] 5 WWR 552 (B.C.C.A.), *370105 Alberta Ltd. v Brazos Petroleum Corporation*, [1993] 3 WWR 186 (Alta. Q.B.), and R*oyal Bank of Canada v Joffre Resources Ltd*, [1995] 5 WWR 75 (Alta. Q.B.).

In this case we have what seems to be an operation for the joint account of the co-owners of the property (Richmount, Twin Peaks and RMU) which is then modified by the desire of one party to share its portion of the risk by bringing in another party (Solara\Dyno), as a participant. Furthermore, since Twin Peaks and RMU were contributing their full share of the costs of the operation, from their perspective this is not an operation for the sole cost, risk and expense of the farmee, but a shared risk operation. The dual nature of the agreements suggests that the parties will see the facts through very different lenses. Take, for example, AFE # 2. On the facts of this case, AFE # 2 would be perceived by Twin Peaks and RMU as the completion AFE as required by Article IX of the Operating Procedure. Presumably, Twin Peaks and RMU actually had an election to make at this point. But from the perspective of Solara\Dyno this was not much of an election; it had to go along with the AFE in order to preserve its chance of earning an interest. While it could also earn its interest through abandonment, abandonment was hardly an option while Richmount as operator was interested in completing the well for production.

The judgment itself demonstrates the competing views of AFE # 3. On the one hand, Solara\Dyno viewed the operation as one that was subject to cl. 1008. On the other hand, at least for Richmount, it was part and parcel of completion, and, as such, Solara\Dyno had to participate

in order to earn. The distinction is crucial since if it was a new operation (albeit a re-working or re-completion operation), the AFE would be void unless all parties approved (cl. 701). Solara attempted to address this by purporting to consent to the operation proceeding as an independent operation notwithstanding the absence of an independent operations notice. Richmount in this situation has a huge incentive to prolong completion for as long as possible so as to get as large a share of the costs as possible covered by the participant; and if it can take advantage of a failure to contribute as evidence of non-completion then it also receives a windfall since its interest is no longer diluted to accommodate the participant.

In sum, the participant in a farmout and participation agreement where the farmor is the operator is very vulnerable, since, if the participant fails to complete, it is left with nothing. The facts of this case offered Justice Martin three different options for extending some degree of protection to the participant: (1) a fiduciary duty analysis, (2) a *contra proferentem* analysis (since Brookfield was the originator of the AFEs it was appropriate to insist upon a strict construction of those instruments against the drafter), or (3) an estoppel analysis. Justice Martin touches upon each of these possible characterizations of the facts but in the end opts for the estoppel approach. Within that frame of reference Dyno\Solara's vulnerability as a participant is used to help characterize the legal implications of Richmount's silence when it learned of Dyno\Solara's assessment of AFE # 3. The outcome seems entirely appropriate.

Dyno's Position in Relation to the Second Well

Dyno's claim in relation to the second well (it is not completely clear from the facts whether this was a second well on the lands subject to earning under the test well, or whether it was in fact what is more conventionally described as an option well) must be that if it had earned in relation to the test well, then it must also have been entitled to participate in the second well.

In order to pursue that claim Dyno had to prove on the balance of probabilities that it would have participated had it been given the chance. Justice Martin concluded, perhaps surprisingly given the initially disappointing results from the test well, that Dyno would have elected to participate. But what should flow from that?

What should flow is that Dyno should be able to earn an interest on the basis of putting up its share of the costs of the well under the terms of the farmout and participation agreement. Its interest should be encumbered by the BPO royalty subject to the right of conversion as contemplated. Although it is not entirely clear, Justice Martin appears to suggest that Dyno should be required to "pay at the penalty rate for all activities" (paras 162 and 163). While this makes sense for that portion of the costs of the test well that are subject to AFE # 3, it does not make sense with respect to the second well. If as Justice Martin concludes (at para 158), Dyno has been able to show that it "would have taken the opportunity to participate in the 11-2 [second] well, had it been offered" then it should follow that it should simply be required to pay its share of the costs on an ordinary non-penalty basis. Participation on a penalty basis is ordinarily reserved for those who elect to go non-consent.

October 11, 2008

When is a Non-Operator Entitled to a Constructive Trust over the Operator's Own Assets?

Written by: Nigel Bankes

Case Commented On: *Brookfield Bridge Lending Fund Inc v Vanquish Oil & Gas Corporation*, 2008 ABQB 444

In this case Justice Bruce McDonald ruled that a joint operator may be entitled to a constructive trust remedy over the assets of an operator, where the operator is in receipt of production revenues attributable to the joint operator and where the operator fails to preserve an amount representing those monies in its commingled bank account. As a result, the joint operator was allowed to take priority over the interests of both secured and unsecured creditors.

The Facts

Karl (55%) and Choice (45%) owned interests in the Simonette property. Karl was the operator and sold its entire interest to Vanquish whereupon Vanquish assumed the role of operator. On March 28, 2007 Vanquish was placed in receivership by Brookfield, a secured lender of Vanquish. The receiver sold the property retaining an amount in reserve to stand in place of Vanquish's assets in relation to Choice's claim to production revenues (in fact, and in another action, Karl also made a claim to those revenues on the basis that Choice had forfeited its interest, but for the purposes of this decision and my comment nothing turns on that point). Vanquish had not remitted production revenues to the joint operator and the amount outstanding was estimated as $320,539.

The property was subject to the Canadian Association of Petroleum Landmen (CAPL) 1990 operating procedure and its clause 507 which expressly authorizes the Operator to commingle its own funds with monies received from or for the account of the joint operators. The clause goes on to provide that joint operator monies, whatever the source, "shall be deemed to be trust moneys and shall be applied only to their intended use and shall in no way be deemed to be funds belonging to the Operator, other than in its capacity as the Joint-Operator's trustee."

Vanquish maintained a main operating account and all its transactions moved through that account. Relevant balances were as follows: March 14, balance of $40,218; March 14, cheques written for $202,267; March 16, a further amount of $40,598 credited to the account as production from Simonette.

The issue before the Court was whether Choice had a claim in trust against other assets of Vanquish to the extent of the unpaid production revenues. Vanquish argued that Choice's claim should be confined to the amount remaining in the joint account at the time of the receivership, at most some $58,000.

The Judgement

Justice McDonald held that the assets of Vanquish (and the proceeds of sale of any such assets) were subject to a constructive trust in favour of the 45% non-operator working interest of the owner of the Simonette property.

Had Vanquish followed the instructions of cl. 507, the full amount owing to Choice would have been in Vanquish's general account impressed with an express trust. This would have afforded Choice a priority against Brookfield. By failing to preserve the full amount of these production revenues in its commingled general account Vanquish was in breach of trust and in breach of its fiduciary duties.

In order to remedy that breach of trust it was appropriate to impose a constructive trust on the assets of Vanquish to the extent of unpaid production revenues on the grounds that: (1) cl. 507 of the CAPL imposed an express trust, (2) Vanquish's remaining asset base was enriched by the breach of trust, (3) it was appropriate to grant a proprietary remedy to ensure that persons in Vanquish's position fulfilled their trust obligations under cl. 507, and (4) it was not unjust to impose a constructive trust in this case having regard to the interests of a secured lender since the secured lender is in a strong position to ensure that its customer adheres to its obligations by employing such things as borrower's covenants, reporting procedures etc. (applying *Soulos v Korkontzilas*, [1997] 2 SCR 217).

Assessment

Some twenty years ago the Alberta Court of Appeal in a decision known as the *Sorel Resources* case, or more formally as *Bank of Nova Scotia v Société Générale (Canada) et al* [1998] 4 WWR 232 decided that the right and power of the operator under the 1981 version of the CAPL operating procedure to commingle excess AFE (authorization for expenditure) monies and joint operator production revenues with its own monies in a general bank account, was not itself fatal to the claim that these monies were impressed with a trust. In fact, on very slim evidence, the Court found that the 1981 CAPL agreement created not just a fiduciary duty in relation to these monies but an express trust. I have always thought that *Sorel Resources* was wrongly decided. The relevant clauses of the 1981 CAPL agreement did not use the language of trust. This was a case in which the Court used the trust label in order to provide the plaintiffs with an effective remedy without seriously considering whether they were entitled to such a remedy. In sum, I thought that the Court was asking itself the wrong question. I thought that the Court should have been asking itself this question: is it appropriate to grant these plaintiffs (joint operators with respect to shared risk operations) an equitable proprietary remedy so as to prevail against both secured and unsecured lenders?

Fast forward to the present and the current decision on the 1990 CAPL form. The provision of the 1990 CAPL form on the right and power of the operator to conduct operations for the joint account using a commingled general account is a "have your cake and eat it" provision. The provision seeks to make it crystal clear that excess AFE monies and production revenues are trust monies. And, unlike the 1981 version, we must all concede that this does amount to a declaration of an express trust. But the clause also permits the commingling practice, no doubt because of the convenience factor. Imagine if every operator of every single separately owned oil and gas property in the province (and remember there may be many separately owned properties with different ownership positions within the confines of a single lease) had to maintain a separate trust account for each of these properties.

But commingling as used in the 1990 CAPL form does not allow an operator to spend those monies since they are trust monies. But given the fact of commingling of a completely fungible commodity the operator cannot have a duty to preserve those specific monies. Instead, presumably what the trustee must do is to ensure that it never draws down its commingled account below the level of its cumulative trust commitments – potentially in relation to multiple properties. If the operator does not succeed in doing that it is in breach of trust. And if it is in breach of trust we must consider the question of an appropriate remedy for the joint operator who, as here, finds that the larder is empty.

One remedy that our operator (and the board of directors of that operator) should have clearly in mind are the provisions of the *Criminal Code* (s.336) dealing with theft by a trustee and criminal breach of trust. But those provisions provide little comfort to the joint operator who is interested in getting its money back rather than incarceration. For the joint operator, the empty larder is hugely problematic especially if there is no possibility of a tracing remedy. In this case, creative counsel hit upon the remedy of constructive trust; a constructive trust over assets of the operator other than those already burdened by the express trust. And this time, I think that the Court did ask itself the correct questions or at least some of them, because it is apparent that the Court, following both Justice LaForest's judgement (for the majority on this point) in *Lac Minerals Ltd v International Corona Resources Ltd* [1989] 2 SCR 574 and *Soulos* (supra) did ask whether an equitable proprietary remedy was appropriate in these circumstances.

The real question then is whether we got the correct result on the application of the relevant tests? In my view Justice McDonald has been too solicitous of the interests of the joint operator and has not accorded enough weight to the exceptional nature of the constructive trust remedy.

In his judgement Justice McDonald focused on the *Soulos* decision in determining whether it was appropriate to award an equitable proprietary remedy. It is at least questionable how relevant *Soulos* should be on these facts. The principal issue in *Soulos* was whether or not it was appropriate to grant an equitable proprietary remedy in the absence of an unjust enrichment. Here I think that it is fairly clear that Vanquish was unjustly enriched by appropriating trust assets. And, if Vanquish had used those trust assets to purchase other specific properties, there is little doubt but that a constructive trust would have attached to those specific properties. The real question in this case is whether a constructive trust should attach to any other properties of the trustee in the absence of a clear connection or nexus between the breach of the express trust and the specific assets to which the constructive trust will apply. That was not an issue in *Soulos*. In that case the very property purchased by the realtor was the specific property that was the subject of the fiduciary relationship.

It seems to me that Justice McDonald glosses over this question and he does so in his application of the first and second criteria from *Soulos*. These criteria read as follows:

> (1) The defendant must have been under an equitable obligation, that is, an obligation of the type that courts of equity have enforced, in relation to the activities giving rise to the assets in his hands;
>
> (2) The assets in the hands of the defendant must be shown to have resulted from deemed or actual agency activities of the defendant in breach of his equitable obligation to the plaintiff;

In the present case, Choice seeks to establish a constructive trust over the operator's interest in the lands (and perhaps other assets as well, the judgement is less than clear as to the subject of the constructive trust). The problem is that the defendant, Vanquish, owes *no* equitable obligation "in relation to the activities giving rise to the asset [the working interest] in his hands". Vanquish owes an equitable obligation in relation to production and the proceeds of production from the lands attributable to Choice, but it owes no equitable obligation with respect to its own lands or its own share of production. Similarly, there is nothing to suggest under the second criteria that the assets (Vanquish's working interest and perhaps other assets) are in Vanquish's hands as the result of the breach of an equitable obligation. In fact, the asset was in Vanquish's hands because Vanquish purchased them from Karl and it is not enough simply to suggest that Vanquish's net asset base has been enriched by Vanquish's breach of trust.

There is a reason why the matter of nexus is important. It is important because one of things that the person seeking the constructive trust has to show is that it is just that that person receives the additional benefits that flow from the right to property – not just any property but some specific property. The plaintiff must have some special claim to that property even if, as Justice LaForest says in *Lac*, it is not necessary for it to establish a "pre-existing right of property". The need for a nexus also informs the rules of tracing; and if a plaintiff cannot trace it is not immediately obvious why a plaintiff should be able to secure the remedy of a constructive trust.

I think that the fourth criterion from *Soulos* should also cause some difficulty for Choice. This criterion requires:

> (4) There must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g., the interests of intervening creditors must be protected.

Soulos was an easy case in relation to this fourth criterion because there were no relevant third parties. In this case the grant of an equitable proprietary remedy stands to benefit the joint operators, not just as against the secured creditor but also as against unsecured creditors. Justice McDonald does not consider the position of such parties in this case (except to observe that monies paid to third parties in breach of the express trust will not be recoverable by the joint operators on the assumption that such third parties can claim to be equity's darling (a bona fide purchaser for value etc.)). Perhaps the claims of unsecured creditors were moot in this case (e.g. if the secured creditor would be able to seize all remaining assets) but it is possible to imagine scenarios in which the preferred treatment of the joint operator will reduce the monies available to meet the claims of general creditors.

But there is also the question of why we should prefer the interests of the joint operator over the interests of the secured lender. The secured lender, says Justice McDonald, can take steps to protect itself, perhaps by insisting on a covenant to maintain a sufficient reserve in its general account to meet all outstanding trust obligations. But one wonders how effective this would be. If the operator is prepared to ignore the implications of an express trust how seriously will it take a mere negative covenant?

Justice McDonald has nothing to say about the options available to the joint operator. These options include the right to select who is the operator and the right to require that the operator maintain a separate trust account! It seems a little disingenuous for the joint operator to argue that the secured lender is in a better position to protect its interest when it is the adoption of the "have your cake and eat it" commingling provision that arms the operator to commit monies in that commingled account to multiple different purposes.

In conclusion, the 1990 CAPL creates an express trust with respect to surplus AFE monies and production revenues attributable to joint operators. But an express trust does guarantee an effective remedy when the pantry is bare. A constructive trust remedy may be available to fill this gap but it is important to ask, as does the trial judge in this case, whether it is appropriate to grant a joint operator an equitable proprietary remedy. A constructive trust is an exceptional remedy and in deciding whether or not to grant that remedy the Court should take account of the interests of general creditors as well as the interests of any secured creditors. One of the ways to do that is to insist that there be a clear nexus between the breach of trust and the specific property that the plaintiff seeks to attach. A joint operator may also be able to take other steps to protect itself, including careful selection and timely removal of the operator.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

June 25, 2009

Court of Appeal Rejects the Constructive Trust Analysis in Brookfield

Written by: Nigel Bankes

Case Commented On: *Brookfield Bridge Lending Fund Inc v Karl Oil and Gas Ltd*, 2009 ABCA 99, reversing 2008 ABQB 444

The Court of Appeal by a 2:1 majority (Justices Frans Slatter and Patricia Rowbotham for the majority, Justice Ronald Berger dissenting) has overruled the decision at trial by Justice Bruce McDonald to impose a constructive trust on the assets of an operator beyond the express trust provided for by clause 507 of the CAPL Agreement.

I had criticized the trial judgement in an earlier post on two main grounds. The first ground was that in deciding to impose a constructive trust Justice McDonald failed to satisfy himself that the case fell within the four criteria of *Soulos v Korkontzilas*, [1997] 2 S.C.R. 217. The second ground was that Justice McDonald failed to give good reasons for granting the joint operator an equitable proprietary remedy thereby defeating the interest of both secured creditors (here Brookfield) and unsecured creditors.I think that the majority of the Court has accepted both of those criticisms. Thus, Justice Slatter emphasised that there was no evidence to suggest that the incremental monies in the commingled account were the fruit of the breach of trust (at para 20). Justice Slatter also concluded that there was no reason to prefer the joint operator over the interests of the secured creditor, Brookfield. It was unrealistic to think that Brookfield was in a position to protect itself from the operator's breach of trust by monitoring the operator's accounts. The joint operator created the risk here by permitting the commingling of trust and non-trust monies (at para 25).

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

cc BY NC ND

November 20, 2009

The Supreme Court of Canada Denies Leave in Brookfield

Written by: Nigel Bankes

Case Commented On: *Brookfield Bridge Lending Fund Inc v Vanquish Oil and Gas Corporation*, 2008 ABQB 444, reversed in 2009 ABCA 99, leave to appeal denied November 19, 2009

The Supreme Court of Canada has denied leave to appeal to the joint operators in the Brookfield Bridge case. The case involves the circumstances under which a joint operator might be able to establish a constructive trust over assets of the operator other than those already impressed with an express trust by the language of clause 507 of the CAPL Operating Procedure in a situation where the operator expends monies from the commingled account for its purposes.

I commented on both the trial judgement (granting the constructive trust) which I criticized, and the judgement in the Court of Appeal (reversing by a majority) .

I really have nothing to add to those comments and I should heed the caution that it is dangerous to read too much into a decision to deny leave; this is more in the nature of a heads up that the Court of Appeal's judgement represents the law in Alberta.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

cc BY NC ND

January 31, 2009

Terminating a Long Term Gas Sales Contract on Account of a Material Adverse Change: The Continuing Fallout from the Collapse of the Enron Empire

Written by: Nigel Bankes

Cases Commented On: *Marathon Canada Limited v Enron Canada Corp*, 2008 ABQB 408; *Marathon Canada Limited v Enron Canada Corp*, 2009 ABCA 31

The Court of Appeal, in a memorandum of judgement authored by Justices Ellen Picard, Peter Costigan and Jack Watson, has affirmed the decision at trial of Justice Terence McMahon of the Alberta Court of Queen's Bench. Justice McMahon held that Marathon Canada had lawfully terminated a natural gas purchase contract with Enron Canada. Marathon chose to terminate when Enron Canada's US parent (Enron Corp) fell into serious financial difficulties. Both courts also held that: (1) Marathon was entitled to recover $560,000 damages for natural gas that it had delivered prior to contract termination, but that, (2) Enron Canada was not entitled to recover liquidated damages of some $126 million based on a counter-claim of wrongful termination and the estimated\guesstimated present value of Marathon's future deliveries at the contract price.

It should be apparent from the size of Enron's damages claim that at the time that Marathon purported to terminate the contract, Marathon was "out of the money" on its contract with Enron; i.e. market prices were above prices provided for in the contract and thus Marathon, but for being able to lawfully terminate the contract, would have been obliged to continue to deliver gas to Enron at a contract price that was lower than the market price. Alternatively, Marathon could have cashed out, but in such a case it would have had to have paid the present value of the outstanding deliveries. In sum, by taking advantage of the termination trigger in the contract Marathon was able to secure for itself a significant windfall since it could now take the gas that had been formerly committed to Enron and sell it into the (higher) market.

This was a particularly bitter pill for Enron Canada to swallow, for while Enron Corporation was obviously in financial difficulty, Enron Canada, the "jewel of the Enron Empire" was in no such difficulty, except to the extent that it was vulnerable (and the extent to which this was actually the case is unclear – see para 37 at trial) to Enron Corporation making calls on Enron Canada's funds.

The Facts

Marathon (M) and Enron Canada (EC) were parties to a master natural gas purchase contract of 1995 with EC as purchaser and M as seller. EC was an indirect subsidiary of Enron Corp., a US company which guaranteed EC's obligations up to $10 million. The master agreement anticipated that the parties would enter into confirmation agreements from time to time specifying details of each transaction. There was one relevant agreement for the period April 1995 – November 2012 which called for the delivery 7,500 MMBtu's per day for a fixed escalating price.

Under the agreement, each party had the right to terminate on two days notice after a "triggering event". The triggering event clause is a complex clause but the court only quotes one such triggering event which is (para 9.3(h)) "the occurrence, in the reasonable opinion" of the notifying party of a "material adverse change" ("MAC") of the other party. This clause provides that an event would not be a triggering event where, *inter alia*, a party established and maintained a letter of credit in the defined amount. No such letter of credit was ever maintained. A material adverse change in the case of EC meant a situation where "Enron Corp. shall have long-term debt unsupported by third party credit enhancement that is rated by Standard and Poors below BBB-".

Enron Corp ran into financial difficulties in the fall of 2001 and by November 28, 2001 S & P had reclassified Enron Corp's credit rating to B-. As soon as M heard this news it faxed Enron Canada alleging a MAC and also purporting to give notice of termination effective December 1, 2001.

Enron Canada was not in any particular difficulty at the time. It would have had the ability to post security if demanded but Enron Corp could and did withdraw money from EC's accounts until EC put a stop to this in November 2001, EC's continuing ability to do so was unclear.

Marathon commenced this action claiming $560,000 for gas deliveries for November 2001 for which it was not paid. Enron Canada counterclaimed on the basis that Marathon had improperly terminated the agreement and seeking damages of $126 million based on the liquidated damages clauses of the agreement and the costs of purchasing replacement gas. Enron Canada argued that industry practice required that M give notice requiring EC to provide performance assurance (e.g. posting a letter of credit or cash) and then giving EC a reasonable time (three to ten days) to perform before the right to early termination arose.

The Trial Decision

Justice McMahon at trial held that M lawfully terminated the agreement and was entitled to damages. Enron Canada's counterclaim was dismissed.

M had formed a reasonable opinion of a material adverse change in Enron Corp.'s status. The agreement chose to measure EC's ability to perform by reference to Enron Corp.

The evidence did not establish an industry practice of notice and opportunity to provide assurance of ability to perform before terminating. In any event, such a practice runs contrary to the plain language of the agreement. Even if industry practice had evolved (as evidenced by other standard forms such as that of the Gas Industry Standard Board (trial at para 123)), that practice should have been incorporated by an amendment to the agreement. Certainty of terms is essential to derivatives trading and certainty is best achieved by unambiguous contract language rather than by superimposing on contract language evidence of industry "expectations".

The duty of good faith (trial at paras 128 – 131) may be relevant to the proper interpretation of a contract but Canadian law does not recognize a free standing duty of good faith independent of the terms of the contract. The exercise of a contractual right of termination is not evidence of breach of good faith. Neither was there unjust enrichment since there was a juristic reason for the enrichment.

There are one and two way gas purchase contracts (trial at para 21). In a two way contract, termination for whatever reason requires that the party who is "out of the money" pay the party who is "in the money" the present value of undelivered gas over the balance of the contract. In the case of a one way contract, the party who is out of the money only pays if it is in default. In this case, M was out of the money in the tens of millions of dollars. While the evidence suggested that there was a trend to adopt two way contracts rather than one way contracts this contract was a one way contract since it only contemplated assessing the damages (if any) incurred by the non-defaulting party (trial at paras 148 – 165). Since the court had already found that M was not in default that was the end of the matter.

Enforcement of a specific provision in a contract could not be a penalty and this was therefore not a case in which EC could seek relief from forfeiture (or a penalty). But even if it were, this was not an appropriate case for relief from forfeiture. The parties had expressly contracted for a one way clause which, depending on the circumstances, might benefit either party. It would be unfair and inequitable to deny enforcement of such a provision. This was not a case of unconscionability or unequal bargaining power (trial at paras 166 – 173).

In the event that it was necessary to establish EC's damages the parties faced the difficulty that they could not comply with the method of calculating damages stipulated by the contract which was to obtain quotes of future prices (at paras 179 & 185). In the absence of that it was not unreasonable to use actual Nymex data until the date of trial. On a forward basis it was unreasonable simply to project out linear price increases until the end of the term of the contract and it was therefore preferable to determine damages based on a Kalman filter model (discussed at trial at paras 59 – 79 and at 179 – 184).

The Appeal Decision

The Court of Appeal in a relatively short memorandum of judgement has affirmed. The Court of Appeal held that the standard of review would be correctness insofar as the issues raised were pure questions of contractual interpretation but that the standard would move to the significantly more deferential "palpable and overriding error" standard insofar as the issues became muddied (my word not the Court's) with issues and evidence as to industry custom and practice and commercial context.

The main issue addressed by the Court of Appeal was the argument that the written terms of the contract needed to be qualified by an understanding of a practice or custom in the industry, according to which Marathon would not be able to terminate unless and until it had accorded Enron a reasonable amount of time to post alternative security for its performance of the contract. The Court of Appeal concluded that this was little more than "an attempt to rewrite the plain terms of the Agreement" (at para 13). And given that this was not a case of ambiguity and given that "the rules for implying terms into a contract are strict and do not favour contradicting the contract's express terms" (*id*) the Court had little difficulty in concluding that the trial judge did not make a palpable and overriding error.

Comment

From one perspective there is nothing very remarkable about the approach taken by both Courts in this decision if the contract were as clear as the Courts suggest. It seems reasonable to conclude that this was a commercial contract (largely drafted by Enron – although s.15.10 (at para 20 of the trial judgement) does acknowledge that both parties prepared the contract and that

it should not be construed against either by reason of its preparation) between sophisticated parties and that there is therefore little room to imply additional terms into such a contract. This seems especially to be the case when there were so many different ways of framing the precondition to utilizing the early termination provision of the Agreement.

In sum, according to this view, if Enron Canada had wanted a situation in which: (1) it was Enron's Canada's credit rating that was crucial to a determination of "material adverse change" rather than that of Enron Corp, (2) either party was required to allow the other to post security to cure an MAC, and (3) the party that was out of the money was required to pay the present value of the balance of the contract regardless of the cause of termination, then Enron Canada was perfectly able to contract for any or all of these entitlements. On a plain reading the contract did not provide for any of these.

But another view emerges if one examines the entirety of the crucial Article 9 (Defaults and Remedies) of the contract. That article provides (as noted above) that a party may serve notice to terminate if there is a triggering event. If there is no triggering event there can be no notice to terminate. The article goes on to define ten (10) forms of triggering event. The crucial point about those 10 individual paragraphs is that while one might expect triggering events to be bright line events, some of the paragraphs undoubtedly contain internal curing provisions which presumably must run their course before one can decide that a triggering event has occurred. For example, s. 9.3(a) provides that a triggering event includes the failure of an affected part to make a required payment. However, the trigger only applies if the failure is not remedied within five days of written notice and the clause is subject to the further proviso that the payment is not the subject of good faith dispute. In sum, a failure to make a payment is not itself a triggering event. It will only be a triggering event if: (1) the affected party fails to remedy and (2) if the payment is not itself the subject of a dispute.

The conditional nature of the trigger in this clause 9.3(a) (also evidenced in some of the balance of the list of ten triggering events) at the very least makes it easier to appreciate why the MAC triggering event might also be read as conditional (and curable) rather than simply self-executing. The relevant text of the MAC clause (and Justice McMahon quotes this part of the clause at para 16)) read as follows:

> 9.3. Triggering Event shall mean with respect to a Party (the "Affected Party"):
> (h) the occurrence, in the reasonable opinion of the Notifying Party, of a Material Adverse Change of the Affected Party; <u>provided that such Material Adverse Change shall not be considered to be a Triggering Event</u> if the Affected Party establishes, and maintains throughout the term hereof, a Letter of Credit (naming the Notifying Party as the beneficiary thereof) in an amount equal to the greater of (i) the Notifying Party's Liquidated Damages or (ii)if the Notifying Party is the Seller, the aggregate of the amounts Seller is entitled to receive during the sixty-Day period preceding the Material Adverse Change. The amount of such Letter of Credit shall be adjusted quarterly if necessary, to cover the Notifying Party's Liquidated Damages at that point in time (emphasis supplied).

The structure of the clause is to provide that a MAC will be a triggering event. But that statement is immediately qualified by the proviso which tells us that a MAC will not be a triggering event in certain circumstances. As any oil and gas lawyer who reads provisos to habendums of leases knows a proviso can serve to re-define relevant terms. The question therefore is not so much "is there a custom in the industry that is inconsistent with the plain meaning of the clause" (a tough hurdle to meet) so much as "what is reasonable commercial interpretation of this paragraph within the context of a whole series of defined triggering events."

In short, this case was perhaps not as clear a case as it seems when one reads the limited extracts from the contract provided by the Court. A more contextualized interpretation of the relevant clauses (and that's what we should be doing – reading the entire contract) calls this into question. The difficulty of course is that the reader has to acquire the contract itself to fully appreciate the more contextualized approach. Absent that it looks like a no-brainer.

Additional Note

In a judgement reported as 2008 ABCA 424 Justice Myrna Paperny denied Marathon's application that Enron be required to provide security for the trial costs (estimated at some $3.5 million). Justice Paperny, applying Rule 524 (which makes it clear that security will not be required except in exceptional circumstances), concluded that Marathon had not made out its case. The fact that Enron Canada was undergoing voluntary liquidation was not a special circumstance in this case. In any event, Marathon had delayed unreasonably in seeking security.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

February 15, 2009

Co-Ownership is a Messy Business (Even with an Operating Agreement)

Written by: Nigel Bankes

Case Commented On: *San Juan Resources Inc (Re), 2009 ABQB 55*

Co-ownership is a legal relationship for parties who are able to get along together. For those who cannot the court will order partition or sale under the *Law of Property Act*, R.S.A. 2000, c. L-7. But co-ownership is also the typical foundation for oil and gas operations in this province and elsewhere since oil and gas companies will typically be tenants in common (working interest owners) of their title documents (the freehold and Crown leases) on which their operations rely.

The CAPL (Canadian Association of Petroleum Operators) standard form operating agreements are designed to supplement the very thin common law default co-ownership rules with detailed provisions as to how the co-owners of an oil and gas property are to get along. But the agreements are still premised on a minimum level of co-operation. The fact pattern underlying this decision of Master John Prowse (sitting as a Registrar in Bankruptcy) shows what happens when even that minimum level of co-operation is absent. It illustrates the vulnerability of a joint operator who fails to take in kind thereby leaving an unscrupulous operator in possession of the entire revenue stream from the property.

Ostensibly the case involved a narrow point of law (should an appeal from the trustee's disallowance of a claim in bankruptcy be an appeal on the record or a de novo hearing) but my interest in the case lies in the oil and gas issues outlined above.

The Facts

Hampstead (25%) was a co-owner with San Juan (75%) in two oil and gas properties of which San Juan was the operator. San Juan persistently failed to account to Hampstead for its share of the proceeds of production from the properties in spite of court orders and subsequent contempt proceedings. Hampstead was about to bring on an application to have the court appoint a receiver to administer San Juan's assets when San Juan filed notice of intention to make a proposal under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (*BIA*), thereby bringing about an automatic stay in Hampstead's action against San Juan.

Hampstead filed three proofs of claim with the trustee which were substantially disallowed. Hampstead appealed and the question before the registrar was as to the form of an appeal. Should it be an appeal de novo or an appeal on the record? The *BIA* (s.135) is silent as to the process to be followed and the existing case law (from the Maritimes and British Columbia) is not entirely consistent.

The Judgement

Master Prowse sitting as the Registrar in Bankruptcy, ordered a de novo hearing following the procedure in Alberta for summary trials with the right to cross examine on expert witness affidavits. In addition, Hampstead was to have the right to reasonable access to documents in the trustee's possession.

While concerns for efficacy, expedition and expense in bankruptcy proceedings would normally point in the direction of an appeal on the record, the Registrar should have the discretion to order a de novo hearing where the circumstances of the case suggest that a hearing on the record might result in an injustice.

In this case it was appropriate to order a de novo hearing. Hampstead needed access to documents in possession of San Juan and the trustee in order to establish its claim to the proceeds of production from solution gas. It would likely have been able to obtain those documents through the discovery process in the action that it had commenced (but which was now stayed). In addition it was essential that Hampstead be able to cross examine experts (presumably experts on oil and gas production accounting matters) as part of the appeal since the trustee had conflicting opinions before it and had preferred San Juan's experts.

Comment

Given the background to this case and the manipulative and fraudulent behaviour of San Juan and its principal (including a false affidavit) it is hardly surprising that Registrar\Master Prowse thought that this was an appropriate case for a de novo hearing. Anything else would have compounded the list of injustices that Hampstead seems already to have suffered. This was certainly not a case (to use the analogy of chambers applications under the current rules of court) where one of the parties does not put its best foot forward and treats the chambers application as a mere stalking horse for the "real" application before the court; this was a case where the bankrupt had effectively made it as difficult as possible for the claimant to make its case.

But the facts also cause one to reflect on what Hampstead might have done to better protect itself in a situation where the parties seem to have been arguing (and San Juan withholding) production monies from the jointly owned properties for over ten years. San Juan's former lawyer certainly knew how to protect himself since he emerges from all of this with a secured claim in the amount of $342,000 – presumably in some part at least for fighting to prevent Hampstead from getting its 25% share of revenues and defending San Juan's principal on contempt charges – but what about Hampstead? What should Hampstead have done? The best option was likely for Hampstead to insist on taking its share of production in kind and separately marketing it – assuming that it had the capacity to do so or could contract for that capacity.

Short of that, the options seem limited. For example, while monies received by San Juan for the sale of Hampstead's share of production would be trust monies (CAPL Article 507, *Sorel Resources* [1988] 4 WWR 232 (Alta. CA) and *Brookfield Bridge Lending Fund Inc. v Vanquish*

Oil and Gas Corporation, 2008 ABQB 444 and my blog of this decision) the operator might still dissipate the trust fund (although but for dissipation cl. 507 should certainly have accorded Hampstead a provable claim in bankruptcy). And all the precedents suggest that it would certainly be difficult for a minority owner to bring about a change of operatorship against an operator and majority owner who resists, even where the operator is in persistent default under the terms of the agreement but particularly in the case of an insolvency: *Norcen Energy Resources Ltd v Oakwood Petroleums Ltd* (1988), 63 Alta. L.R. (2d) 361 (QB), *Mutual Oil and Gas Ltd v DSWK Holdings Ltd* (unreported judgement of Justice Kenny, January 5, 1996, rev'd on appeal [1996] AJ 582), and *Rimoil Corporation v Hexagon Gas Ltd*, unreported May 5, 1989 (Alta. QB); but for a case in which the new operator successfully sought the assistance of the court to give effect to a change of operatorship (see *Signalta Resources Ltd v Land Petroleum International Inc*, [2007] AJ 496, 2007 ABQB 290).

For other litigation involving San Juan Resources and default under the operating agreement (although this time as a joint operator) see *Energy Power Systems v San Juan Resources Inc* [2006] AJ 956, 206 ABQB 583.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

April 9, 2009

Extraordinary Times Justify Extraordinary Remedies: Interim Measures under the AIPN Standard Form Operating Agreement

Written by: Nigel Bankes

Cases Commented On: *BG International Limited v Canadian Superior Energy Inc*, 2009 ABCA 127; *BG International Limited v Canadian Superior Energy Inc*, 2009 ABCA 73

This is the first Alberta and indeed Canadian decision to consider the standard form operating agreement of the Association of International Petroleum Negotiators (AIPN) (2002). The Court of Appeal has upheld the order of Justice Barbara Romaine [unreported, February 11, 2009] sitting in chambers to issue an interim receivership order with respect to Canadian Superior Energy Inc's (CSEI) interest in an exploration property in the offshore area of Trinidad and Tobago. In the course of doing so the order effected a change of operatorship and provided significant interim relief to BG International (BGI) in order to preserve the jointly owned property and to ensure continued drilling and testing operations.

The Facts

The case involved a property located off the coast of Trinidad and Tobago. There was a semi-submersible rig on site and CSEI was the operator under the AIPN 2002 form. BGI paid its share of monthly invoices from CSEI but the monies were not forwarded to the rig operator and owner, Maersk. Maersk began default proceedings under the drilling contract with the risk that drilling would be suspended and the rig moved off-site. BGI in turn alleged default under the operating agreement and commenced arbitration proceedings as provided for under that agreement before the London Court of International Arbitration. The alleged defaults included CSEI's failure to pay its share of expenses and commingling of monies in breach of Article 4.8 (presumably Alternative 1) of the AIPN form. BGI also commenced an application in the Alberta Court of Queen's Bench to be heard on an expedited basis for a partial receivership order (relating solely to this project).

The Court, relying on its inherent jurisdiction, granted the Order as well as certain ancillary orders designed to provide security for monies that BGI would advance to allow the operation to continue. In addition, the order had the effect of displacing CSEI as operator. The chambers judge granted the order.

The Appeal

On appeal, the Court of Appeal refused to interfere with the decision of the chamber's judge. The Court reasoned that the standard of review for the exercise of such a discretionary power (based on the inherent jurisdiction of the court and that it be "just or convenient" in the circumstances (at para 17) and *Judicature Act*, R.S.A. 2000, c. J-2, s.13(2)) was an error of law or wholly unreasonable exercise of discretion (at para 6).

That said, the Court was at pains to emphasise that the appointment of a receiver to protect property pending the outcome of an arbitration was an extraordinary remedy (at para 17):

> … the appointment of a receiver is a remedy that should not be lightly granted. The chambers judge on such an application should carefully explore whether there are other remedies, short of a receivership, that could serve to protect the interests of the applicant. For example, the order might be granted but stayed for, say, 48 hours to allow the company to cure deficiencies, propose alternatives, or clarify the record.

In the end, and notwithstanding the risk of serious damage to Canadian Superior arising from the mere fact of granting the receivership order, the Court of Appeal held that it was not an unreasonable exercise of discretion. It was in the interest of all parties "that the rig stay on the well and that the well be flow tested" (at para 18) and this was an effective way of allowing that to happen.

Comment

I will comment in more detail on three matters: (1) the availability of interim relief, (2) replacement of operator, and (3) security for BGI's advances.

The Availability of Interim Relief

Article 18 of the AIPN operating agreement [and my references here are to the standard form, I have no knowledge of how the parties might have amended the terms of the AIPN except as indicated in the judgement] expresses the strong preference that all disputes not resolved through ADR shall be "exclusively and definitively resolved through final and binding arbitration". However, clause 18.2C(10) [9 in the judgement] also provides for an application to a court for interim measures as stipulated below.

> Interim Measures. [Notwithstanding any requirements for alternative dispute resolution procedures as set forth in Articles 18(B) and (C)], [a]ny party to the Dispute may apply to a court for interim measures (i) prior to the constitution of the arbitral tribunal (and thereafter as necessary to enforce the arbitral tribunal's rulings); or (ii) in the absence of the jurisdiction of the arbitral tribunal to rule on interim measures in a given jurisdiction. The Parties agree that seeking and obtaining such interim measures shall not waive the right to arbitration. The arbitrators (or in an emergency the presiding arbitrator acting alone in the event one or more of the other arbitrators is unable to be involved in a timely fashion) may grant interim measures including injunctions, attachments and conservation orders in appropriate circumstances, which measures may be immediately enforced by court order. Hearings on requests for interim measures may be held in person, by telephone, by video conference or by other means that permit the parties to the Dispute to present evidence and arguments.

In this case relief was sought pending hearing of the arbitration (at para 5). The Court of Appeal commented that the reference in the last sentence to electronic hearings did not preclude court applications which were ex parte or effectively ex parte. (It was contended that the original application was effectively heard ex parte because although notice was provided the matter was brought on very quickly and Justice Romaine denied CSEI's application for an adjournment to allow it to file affidavit evidence (at paras 5 & 9)). The Court noted that it was not uncommon

for receivers to be appointed on an ex parte basis and there were remedies available to review or withdraw the order (at para 9).

Replacement of Operator

The interim receivership order provides the receiver with extensive powers to operate the property but also provides that "The Receiver is directed to retain BGI to assist it in carrying out its duties" under the order. Accordingly, the order effected a change of operator without going through the change of operator provisions of the AIPN (Article 4) which, as the Court acknowledges, would have taken at least 30 days (at para 14). Given the difficulty (and the case law attests to this) in triggering the replacement of operator provisions of the CAPL agreements (see the cases including *Norcen Energy Resources Ltd v Oakwood Petroleums Ltd* (1988), 63 Alta. L.R. (2d) 361 (QB); *Rimoil Corporation v Hexagon Gas Ltd*, unreported May 5, 1989 (Alta. QB); *Mutual Oil and Gas Ltd v DSWK Holdings Ltd* (unreported judgement of Justice Kenny, January 5, 1996, rev'd on appeal [1996] AJ 582) (dealing with the challenge provision under CAPL) and *Kaiser Francis Oil Company of Canada v Bearspaw Petroleum Ltd.* (1999) 240 AR 59 (QB) (dealing with a pre-CAPL agreement)) this approach to the problem has obvious merit from the perspective of the aggrieved joint operator that wants an effective remedy.

CSEI is now under the protection of the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 ("*CCAA*"). It remains to be seen if this interim order will continue. The Court of Appeal warned that its dismissal of the appeal was not (at para 20) "intended to limit the powers of the chambers judge or the *CCAA* case management judge. The receivership was to be "interim" only, and it has an internal mechanism for review. The Queen's Bench retains the ability to revoke or amend the order as circumstances dictate."

Security for BGI's Advances

The default provisions of the AIPN agreement are quite different from anything in the CAPL form. In particular, Article 8 of AIPN contemplates that when a notice of default is delivered and where the default is not rectified the non-defaulting parties are required cover the shortfall. BGI acknowledged that it had this responsibility and tendered the relevant monies (US$47 million) but sought to do so with the benefit of a Receiver's Certificate which provided BGI with a charge on CSEI's assets, second only to the charge claimed by CSEI's principal banker up to the amount of Cdn $14 million.

CSEI argued that this strategy effectively allowed BGI to put itself in a better position than it would have been in under the terms of agreement. The Court was clearly not concerned about this. It noted (at para 13) that clause 8.4(H) of the AIPN [referred to as Article 18 in the Court's judgement] agreement stipulated that the remedies provided by the agreement are in addition to any that might be available to the non-defaulting parties "whether at law, in equity or otherwise" but it also suggested that the certificates would not prejudice the interest of third parties:

> The enhanced security collaterally obtained by [BGI] through the use of receiver's certificates has not been shown on this record to create any serious prejudice to [CSEI]. After all, it is [CSEI] that is in default, and [BGI] is prepared to advance significant sums to cure that default, even if it is required to do so by the contract. The chambers judge found that [CSEI] had been commingling joint venture funds, and that [BGI] had a reasonable concern about the protection of future advances. Unlike in most receivership cases, the funds advanced under this enhanced security are to be used to pay other creditors, and would not further subordinate their interests [at para 13].

The last sentence may well follow for creditors in relation to this particular property. It is not clear to me that the effect of the certificate is equally neutral in relation to other creditors of CSEI.

Conclusions

This is clearly an unusual case and an extraordinary remedy. The stakes were high and this was an expensive operation. The matter was urgent given that a rig was on location. It will not be every case in which a joint operator, confronted with a defaulting operator, will be able to do an end-run around the terms of the agreement (whether AIPN or CAPL) and secure effective relief through the appointment of a receiver. This remedy will remain an exceptional remedy. However, given the difficulty that faces a joint operator in getting rid of an insolvent joint operator (especially one under *CCAA* protection), it will not be surprising if tough times in the oilpatch and concerns about commingling operators (see my blog of *Brookfield Bridge Lending Fund Inc. v Vanquish Oil and Gas Corporation*, 2008 ABQB 444) trigger similar applications, even if the circumstances are not quite as compelling. If that happens, the Court will need to come up with something with a little more bite and structure than "just and convenient" since decisions once made by a chambers judge in expedited circumstances and typically without reasons will be very difficult to overturn on appeal given the applicable deferential standard of review. See *Kerr on Receivers* (17th ed, 1989), esp. c.1, principles.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

April 21, 2009

Rights of First Refusal in a Package Sale of Oil and Gas Properties: A Follow Up to Chase Manhattan

Written by: Nigel Bankes

Cases Commented On: *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

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).

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

November 10, 2009

When, if at all, does a Pooling Agreement Trigger an Area of Mutual Interest Obligation?

Written by: Nigel Bankes

Case Commented On: *Hunt Oil Company of Canada, Inc v Shell Canada Limited*, 2009 ABQB 627

In a 1994 decision, *Luscar v Pembina Resources Ltd* (1994), 162 AR 34, the Alberta Court of Appeal cast doubt on the proposition that Y, a lessee of a tract within a drilling spacing unit (DSU), who enters into a cross conveyance pooling agreement with Z, a lessee of a different tract within the same DSU, will invariably trigger an area of mutual interest (AMI) obligation that Y owes to X with respect to the undivided interest that Y acquired within Z's tract by virtue of the pooling agreement.

In this decision, Justice Alan Macleod has extended that line of reasoning and has decided (subject to the language used in any particular case) that Y will not trigger an AMI obligation, not only in the narrow situation described above but also in the situation where Y and Z, holding adjacent lands, enter into a pooling agreement to improve project economics and not for the purpose of forming a drilling spacing unit.

The Facts

Shell as farmor and Hunt as farmee entered into a farmout and participation agreement in relation to certain lands in British Columbia. The parties used the 1997 CAPL Farmout and Royalty Procedure. Hunt participated in a well on the Block A lands and earned an interest. Hunt ultimately declined to exercise its option to participate in a further well on the Block B lands and as a result did not earn an interest in the Block B lands.

In order to improve the economics of operations on the Block B lands, Shell subsequently entered into a non-cross conveyance pooling agreement with Talisman in relation to the Block B lands and adjacent lands held by Talisman. Production was obtained from the Talisman lands and shared with Shell under the terms of the pooling agreement. Hunt argued that the interest that Shell had acquired under the pooling agreement in relation to the Talisman lands triggered the AMI clause of the farmout agreement and that therefore Shell was obliged to offer to share that interest with Hunt.

The Decision

Justice Macleod held that the pooling agreement did not trigger the AMI clause (at para 49); he also held in the course of his reasons that the expert evidence that had been called did not support the claim that there was an industry custom to the effect that entering into a pooling agreement would trigger an AMI (at paras 36 – 39).

In reaching the main conclusion that the pooling agreement did not trigger the AMI obligations, Justice Macleod develops four main reasons (although I should caution the reader that I am, to some extent, imposing this framework on the judgement).

First, (at paras 41- 42) Justice Macleod reasoned that the purpose of an AMI clause is to avoid competition between the parties to acquire interests in adjacent lands. Given that purpose it would be inappropriate to include acquisition by pooling within the scope of an AMI because a party in the position of Hunt could never have acquired an interest in the Talisman lands by means of a pooling since Hunt was not in a position to offer the *quid pro quo* i.e. an interest in the Shell Block B lands. Hunt would have been able to participate in that trade had it elected to participate in the option well and earned an interest in the Block B lands but Hunt had declined to do.

Second, there really was no acquisition here. Shell's overall interest in the pooled lands was no greater after the pooling agreement than before; the pooling "is financially neutral" (at para 43).

Third, even if the pooling agreement afforded Shell an acquisition, not all acquisitions fall within the terms of the AMI clause. In particular, Justice Macleod seems to have proceeded on the basis that the parties all conceded that forced poolings and "poolings in the face of regulatory authority" (at para 46) (and perhaps also unitizations) did not trigger the AMI obligations and therefore it was not obvious that this sort of voluntary pooling agreement should trigger the AMI obligations either.

Fourth, the AMI clause in the farmout agreement (s.8.04A) contemplates that where the obligation is triggered, the party electing to participate "will pay the corresponding share of the cash consideration of that acquisition" to the other party. Since there is no cash consideration in a typical pooling agreement (just a sharing of rights and obligations on an acreage or reserves basis) this might be taken as evidence that the parties did not intend that the AMI obligation apply to pooling agreements.

Before reaching this conclusion and reasoning as above, Justice Macleod also conceded that it is not possible to establish general rules about the triggering effect of pooling agreements on AMI clauses. Ultimately it must always be a question of interpretation of both the AMI clause (what does the AMI clause say about the trigger?) and the pooling agreement (what new rights does Shell acquire?). Given this acknowledgement, it is perhaps a little surprising that Justice Macleod's judgement does not provide us with the text of the pooling agreement in question. All that we know of the pooling agreement is that: (1) the agreement is described as a non cross-conveyed pooling agreement (at para 13) (and we can perhaps infer from that that Shell did not acquire an undivided interest in Talisman lands and that Shell's interest was likely simply a contractual interest), (2) the agreement was not entered into for the limited geographical and legal purpose of forming a drilling spacing unit, but to improve the economics of the play, (3) the agreement was a "voluntary exploratory pooling arrangement" (at para 31) (and we can reasonably infer from that that it covered a much larger area than the standard DSU under the B.C. legislation, the *Petroleum and Natural Gas Act*, R.S.B.C. 1996, c.361); and (4) the pooling seems to be based on acreage rather than reserves. We do not know if the pooled area was based on mapping of an underlying reservoir and we do not know if the pooling was confined to a particular formation.

We know much more about the AMI clause since we know that it is the CAPL standard form and Justice Macleod summarizes the effect of the main provisions at paras 22 and 47 of his

judgement. The CAPL standard form deals with AMI issues in the definition section ("'Mutual Interest Lands' has the meaning set forth in the head agreement …"), in Article 8 (the standard terms), and in the head agreement (the business variables of the deal which will tell us the area covered by the AMI obligation and the duration of the AMI rights).

Article 8 (8.03) tells us that the AMI obligation is triggered when a Party acquires "Mutual Interest Lands <u>or rights thereto</u>" (here the underlining is mine and I note as well that I have taken this provision from the standard form itself – Justice Macleod does not quote this part of the agreement and I can only assume that the parties had not modified this particular provision) and "if that acquisition is included within the definition of Mutual Interest Lands" then "the acquiring Party will acquire those Mutual Interest Lands <u>or rights</u> subject to the rights of the other Parties under this Article" (emphasis added).

Absent the actual language of the pooling agreement it is very difficult to assess Justice Macleod's conclusions so I shall end this blog post with three observations. The first is that the AMI language of the CAPL Agreement is broad. By inserting the words "or rights thereto" the parties seems to have contemplated that the AMI obligation might be triggered not only through the acquisition of an interest in land (as through a cross conveyance) but also through the acquisition of other rights such as a contractual right to a share of production.

The second is that we might reasonably be cautious in applying *obiter* statements made in the context of a pooling agreement entered into to complete a spacing, to a very different type of pooling arrangement – indeed an arrangement that I would not describe as pooling at all. The pooling that occurred in *Luscar* was a pooling to make up a spacing unit. That, I believe, is the traditional usage of the term "pooling" and it is certainly the way that the term is used in provincial oil and gas conservation legislation in both Alberta (*Oil and Gas Conservation Act*, R.S.A. 2000, c. O-6, s.80) and British Columbia (*Petroleum and Natural Gas Act*, supra, s.68). If the term pooling is confined to a DSU this means that any acquisition and dilution of interests that occurs through pooling is geographically quite confined. Furthermore, we can also say that in *Luscar* some form of pooling was legally essential in order to produce the property. That is not the case on this fact pattern. Shell was not legally required to pool in order to produce from the Block B lands. Pooling to make up a drilling spacing unit is not pooling to spread risk or pooling to improve project economics – both of which seem to have been the drivers as between Shell and Talisman. I think that this should make it harder to conclude that this arrangement did not trigger the AMI. And certainly, calling something a pooling agreement for the purposes of taking the benefit of a dictum cannot make something a pooling agreement.

Third, the golden rule of interpretation is that the interpreter must seek to give effect to the intentions of the parties based on the words that the parties have chosen to use. Justice Macleod's approach here seems very purposive, and, as I have noted above in reading his judgement we must struggle with the fact that as readers we lack access to the words used by the parties in their

pooling agreement. But some may think that this puts me on difficult ground. After all, in taking such a purposive approach to the interpretation of the AMI clause Justice Macleod purports to rely (and generously so) on an article on pooling agreements that I wrote some fourteen years ago: Bankes, "Pooling Agreements in Canadian Oil and Gas Law" (1995), 33 Alberta Law Review 493.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

January 11, 2010

Provincial Court Royalty Calculation Decision

Written by: Nigel Bankes

Case Commented On: *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.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

March 25, 2010

Challenge Notices Under the Terms of the 1990 CAPL Operating Procedure

Written by: Nigel Bankes

Case Commented On: *Diaz Resources Ltd v Penn West Petroleum Ltd*, 2010 ABQB 153

This case will be of interest to the oil and gas bar for two reasons. First, the case provides some guidance as to the quality of the information that a joint operator must provide to support a challenge notice. Second, the case raises (but does not resolve) a question as to whether or not a challenging joint operator also carries the burden of establishing that it is capable of operating the property in a "good and workmanlike manner."

The Facts

Diaz issued a Challenge Notice to Penn West (PW) under cl. 203 of the 1990 CAPL (Canadian Association of Petroleum Landmen) operating procedure in relation to three properties held equally as to 50% undivided interests. The Notice stipulated that Diaz would not charge the joint account for any costs attributable to a production office, a field office or to first level supervisors in the field.

PW took the position, in a timely way, that the Notice was deficient in that it did not provide sufficient information to assess whether the proposal was more favourable to the joint account or not, or if Diaz would be able to conduct operations in a safe and good and workmanlike manner. In addition, PW was of the view that Diaz might be in default under the agreement given the magnitude of unresolved receivables as between PW and Diaz.

Diaz commenced this application under Rule 410(e) of the *Alberta Rules of Court*, Alta. Reg. 390/1968, seeking a declaration that since PW had failed to elect either option prescribed by the CAPL form ((1) agree to operate on the proposed terms, or (2) resign) PW must be taken to have resigned leaving Diaz as operator.

The Decision

Justice Colleen Kenny denied the application. Diaz failed to support its Notice with the information required by cl. 203 to allow PW "to evaluate the nature of the challenge notice and to measure the effect the revised terms and conditions would have on joint operations." In particular, Diaz failed to provide as part of its Notice two types of information that it later provided by way of affidavit to support the present application. This later information detailed the specific costs savings but it also provided that Diaz would continue to retain an existing contractor thereby speaking (belatedly) to the ability to operate in safe and workmanlike manner.

Although this was sufficient to dispose of the application Justice Kenny also noted that to the extent that PW put at issue the ability of Diaz to assume the operatorship, that matter would have to proceed by way of statement of claim, discovery and trial.

Discussion

The CAPL operating procedure contemplates a number of ways in which the joint operator(s) can obtain a change in the operatorship: (1) for insolvency or similar reasons or purported assignment of the operatorship, (2) by vote, or (3) by notice of default signed by a majority of parties (other than the operator) and where the default remain unrectified. The case law suggests that a joint operator will face an uphill battle against an incumbent who wishes to retain its position: *Norcen Energy Resources Ltd v Oakwood Petroleums Ltd* (1988), 63 Alta. L.R. (2d) 361 (QB); *Rimoil Corporation v Hexagon Gas Ltd*, unreported May 5, 1989 (Alta. QB); *Mutual Oil and Gas Ltd v DSWK Holdings Ltd* (unreported judgement of Justice Kenny, January 5, 1996, rev'd on appeal [1996] AJ 582) (dealing with the challenge provision under CAPL) and *Kaiser Francis Oil Company of Canada v Bearspaw Petroleum Ltd.* (1999), 240 AR 59 (QB) (dealing with a pre-CAPL agreement).

In addition to the three ways outlined above there is also the challenge provision in cl. 203 which allows the joint operator to offer to operate the property on more favourable terms. Where that offer is accepted, or the incumbent decides to "renew" on those more favourable terms, the new (or renewed) operator is required to swallow any costs in excess of those set out in the challenge notice. The commentary to the 1990 CAPL is instructive:

> By limiting a challenge to an offer to conduct operations on "more favourable" terms and conditions than the operator, the challenger faces a serious, if not insurmountable obstacle. Since one is unable to quantify qualitative changes, the provision seems limited to financial terms. However, how can a challenger give any more than its best cost estimate when the costs of exploration are a function of such factors as weather conditions, exploration success (testing costs), mechanical difficulties, the demand for equipment and inflation? A challenge on the basis of terms and conditions, therefore, might in practice only be the right to challenge on the basis of overhead rates. Moreover, a challenge on the basis of financial terms ignores the consideration that the basis of a challenge may be the operator's technical rather than cost performance.

The commentary recognizes the difficulty that the challenger faces. Implicit in this is the idea that the incumbent operator is better placed to identify where it might be possible to identify efficiencies. Given these practical difficulties one should perhaps be careful not to be too demanding of the information that the challenger must adduce in support of its challenge. But in this case the challenger seems to have provided only the barest information. One way to read Justice Kenny's short judgement is to say that the joint operator has a duty to put its best foot forward (just as in an application before a master in chambers!) at the time that it serves the Challenge Notice – and if it can adduce evidence by way of affidavit to support a later application for a declaration that it could just as easily have provided that at that earlier time then not only is that too late but also the challenger should not expect much sympathy.

In the present context it is also of interest to note that the commentary makes no reference to Penn West's suggestion that in addition to offering to serve on more favourable terms the challenger also bears the burden of establishing that it has the capacity to be a competent operator who will take charge of and conduct operations for the joint account in a good and

workmanlike manner. This is of course the standard expected of an operator and in cl. 304 of the agreement the challenger covenants that it can and should be held to that standard if it becomes the operator. The question for present purposes is whether a challenger must provide evidence to support its capacity to meet that standard as part of its Challenge Notice. Justice Kenny seems to have some sympathy for this view ("It is clear under Clause 203 of CAPL that the challenger must be ready, willing and able" to conduct operations (at para 17)) but I think that this goes a step too far if this serves to erect another condition precedent that the challenger must meet before it can even have its proposal taken seriously. This would leave too much to the auto-interpretation of the incumbent operator who would simply say that an inexperienced joint operator could never have the competence to assume the operatorship. If that is the intent in the industry, then that intent needs to be expressed more clearly than the "ready, willing and able" formulation of the 1990 CAPL form. For as the commentary indicates, it is already very difficult for a joint operator to put together a challenge notice that is not a leap into the dark; the idea that there is a further condition precedent would make the challenge provisions little more than a dead letter.

In this context it is perhaps pertinent to note that the "ready, willing and able" language has been dropped from the 2007 CAPL form. The relevant commentary is essentially unchanged.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

October 5, 2010

Injunction Denied in Oil and Gas Right of First Refusal Case

Written by: Nigel Bankes

Case Commented On: *NAL GP Ltd v BP Canada Energy Company*, 2010 ABQB 626

NAL was the successor in interest to an agreement between BP and Spearpoint which afforded each party mutual rights of first refusal (ROFR). The agreement (which was not a Canadian Association of Petroleum Landmen (CAPL) form) apparently covered a number of different properties. In July 2010 BP announced that it had reached an agreement with Apache to sell certain assets including the assets subject to the ROFR. There were negotiations surrounding the possible waiver of the ROFR but on September 1 NAL requested that BP prepare the ROFR notices required by the agreement. BP did so. The notices (12) were delivered September 20. The aggregate value of the 12 packages was $1.56 billion. The total sale price was $3.25 billion (US). The agreement required the ROFR to be exercised within 15 days.

In this application NAL sought a declaration that the notices were deficient or alternatively a temporary injunction. NAL also sought to examine documents relating to the sale and oral discovery of representatives of BP and Apache and sought to abridge the 15 day notice period.

The Decision

Justice Hawco denied the application for injunctive relief.

Following *Chase Manhattan Bank of Canada v Sumoma Energy Corp*, 2001 ABQB 142 (aff'd 2002 ABCA 286 although not cited by Justice Hawco), a case dealing with the 1974 CAPL Operating procedure, the agreement did not require BP / Apache to set out the basis for allocating value to particular properties. There was no evidence that the proposed allocation of value was prepared in bad faith. As a result there was no serious issued to be tried (applying *RJR-MacDonald Inc. v Canada (AG)*, [1994] 1 S.C.R. 311). That was sufficient to deny the application for an injunction, but in addition there was no irreparable harm (NAL could be compensated in damages, or, if it wished it could protect its position by exercising the ROFR and seek compensation in damages), and the balance of convenience did not favour an injunction since NAL was seeking something to which it was not entitled (discovery of the method of allocating the purchase price). To grant the injunction would make the time limits set out in the agreement for exercising the ROFR meaningless.

Comment

On the basis of what we learn from the judgement about the terms of the agreement there does not seem to be anything especially remarkable about this case. But, like *Chase Manhattan*, it confirms that the holder of the ROFR rights will always be in a difficult position in the context of a package deal in the absence of some contractual language that requires the vendor to justify the

allocation of value between properties or provides for arbitration of the question (as in CAPL 1990, Article 2401, Alternate B (c)). The law seems to be that the holder of the ROFR rights must show a breach of the implied duty of good faith in order to question the allocation of value and yet, absent discovery, it is unlikely to have any solid basis on which to make such an allegation stick. This leaves the vendor in the driver's seat and meanwhile time continues to run against the holder of the ROFR rights; and if there is one rule that is clear it is that the holder of the ROFR or option rights must comply punctiliously with the terms of the option including any timelines.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

May 2, 2012

More Grist for the Mill, Another Case of Gross Negligence under CAPL 1990

Written by: Nigel Bankes

Case Commented On: *Trident Exploration Corp (Re)*, 2012 ABQB 242

An operator under a pooling agreement who agrees to take charge of responding to a Crown offset notice and who fails to do so and fails to inform tract owners that it is no longer intending to respond, is grossly negligent within the meaning of Article 4 of the 1990 CAPL Operating Procedure.

The Facts

The ownership position in relation to the subject lands was as follows: north half, Crown lease, registered in the name of Blaze (the Blaze lease), but with a number of parties (the Mutiny interests) holding beneficial interests in the lease; south half, two tracts, Trident was the lessee of tract 1 and Bearspaw and Kaplan were the lessees of tract 2. Both of these south half leases appear to be Crown leases. The lands were subject to a non-cross-conveyed pooling agreement, to which was attached a CAPL 1990 Operating procedure. Trident was appointed as operator.

On June 7, 2005 Alberta Energy issued an offset notice to Blaze in relation to Blaze lease. It would appear that similar notices were sent to Trident and Bearspaw in relation to the south half leases. Blaze provided Trident with a copy of the notice in a timely way. The notice informed each lessee of its options under s 20 of the *Petroleum and Natural Gas Tenure Regulation*, Alta. Reg. 263\97 one of which is to pay a compensatory royalty. A well was spudded in on the pooled lands but by November it became clear to Trident that it would not be put on production by December 7, the end of the notice period contained in the offset notice. Accordingly, Trident sent a letter to Mutiny, Bearspaw and Kaplan (November 10) advising of the delay and recommending as operator that, the meantime and pending attaining production, the offset obligation

> …be satisfied by paying the offset compensation to the Crown. Trident will make the payment to the Crown and invoice the partners at their pooled interest share.
>
> Please provide your approval/non-approval of this recommendation in the space below and return it to the undersigned. As we wish to satisfy this obligation as soon as possible, your prompt response will be appreciated.

Prior to that, the landpersons for Mutiny and Trident had spoken and Mutiny had advised that it was agreeing to Trident's proposal. Given that conversation, Mutiny felt no need to respond in writing. Bearspaw however did respond in writing indicating that Trident should not reply to the Crown on behalf of all the tracts and that Bearspaw would send its own response. Trident did not copy Mutiny on this reply and took no further steps to respond to the Crown offset notice (at

least in relation to the Blaze lease). As a result the lease lapsed. All parties acknowledged that Trident would only be able to respond to the notice as it applied to the Blaze lease through Blaze as the designated representative or with Blaze's consent. Mutiny only learned that the lands had lapsed some months later when reviewing some public documents – well after the 60 day period within which a lessee may request reinstatement. The lands were subsequently reposted. Trident put in a bid on the lands but the lands were acquired by Bearspaw.

Trident applied for protection under the *Companies Creditors Arrangement Act*, RSC 1985, c C-36 and subsequently a matter was set down for the Court in relation to the above facts and raising the following question: does Trident have any liability to the Mutiny interests?

The Decision

Justice Kent held that Trident was in breach of its obligations as operator under Article 401 of the operating procedure and that Trident's behaviour amounted to gross negligence. The proper interpretation of the letter and the earlier conversation was that Trident was going to take on the responsibility of informing the Crown of the election under the offset notice (at para 22). The distinction that Trident sought to draw between: (1) responding to the notice, and (2) agreeing to assume responsibility for making any offset payment was not reasonable. Trident could not hide behind the fact that Blaze was the designated representative. Having initially assumed responsibility, "Trident's failure to advise the parties that each was responsible for responding to the offset notice once Bearspaw took the position that it did was negligent." (at para 22)

Trident's failure was not just negligent, it was grossly negligent. After referring to the Court of Appeal's decision in *Adeco Exploration Company Ltd v Hunt Oil Company of Canada Inc*, 2008 ABCA 214 (see post here) Justice Kent concluded (at para 24):

> What Trident did was not a momentary lapse. It wrote a letter that can reasonably be interpreted as meaning that Trident would respond to the offset notice on behalf of all the partners. It received word from Bearspaw that it did not want Trident to respond on its behalf and that each partner should look after its own lease. Trident's failure to advise Mutiny that the plan had changed was something that could have been easily accomplished. Moreover, it was not a mistake which happened in a few seconds or a few minutes after which nothing could be done. The responses had to be to the Crown by December 7. Bearspaw gave its reply to Trident on November 15. There was plenty of time for Trident to ensure that all partners understood what their obligations were, given Bearspaw's response. That is gross negligence.

That was enough to be able to respond to the question posed. Justice Kent did not go on to consider the question of remedies.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

September 13, 2012

Issuance of a Notice of Abandonment under Clause 1201 of CAPL is an Attempt to Exercise a "Right to Remedy" within the Meaning of the Typical Stay Provisions of a Receivership Order

Written by: Nigel Bankes

Case Commented On: *Baytex Energy Ltd v Sterling Eagle Petroleum Corporation*, 2012 ABQB 539

The Facts

Baytex and Sterling held 50% working interests in certain properties by way of various agreements of 1995 and 1996. The properties were also subject to the terms of the CAPL Operating Procedure. There were a number of producing wells on the joint lands and four non-producing wells. Sterling was placed in receivership in June 2011 and the terms of the Receivership Order were brought to the attention of Baytex in August 2011. Revenues from the producing wells continued to be paid to the Receiver. The Order, conventionally, provided that:

All rights and remedies (including, without limitation, set-off rights) against the Debtor, the Receiver, or affecting the Property, are hereby stayed and suspended except with the written consent of the Receiver of leave of this Court, provided that nothing in this paragraph shall (i) empower the Receiver or the Debtor to carry on any business which the Debtor is not lawfully entitled to carry on, (ii) exempt the Receiver or the Debtor from compliance with statutory or regulatory provision relating to health, safety or environment, (iii) prevent the filing of any registration to preserve or perfect a security interest, or (iv) prevent the registration of a claim for lien.

In January 2012 Baytex delivered to MNP (as Receiver for Sterling) four notices of abandonment for the four non-producing wells on the joint lands. Clause 1201 of CAPL provided that:

1201 PROCEDURE FOR ABANDONMENT – If a party proposes to abandon a well on the joint lands … it shall give notice of the proposed abandonment to the other parties. Within thirty (30) days of receipt of the notice, each of the other parties shall elect, by notice to the other parties, whether it wishes to take over the well. Failure by a party to respond to such notice shall be deemed to be an election by that party to take over, or participate in the takeover, of the well.

Baytex followed this up with a letter in February advising that failure to respond was a deemed election to take over the wells. The Receiver relied on the stay provision in the Order and ultimately indicated that it would consent to the lifting of the stay so as to allow Baytex to issue the notices of abandonment

Baytex brought this application for an order to lift the stay and for a further order compelling the Receiver to accept a transfer of the four wells.

The Decision

Justice Strekaf lifted the stay to allow the application to be brought but denied the application for an order compelling the Receiver to accept a transfer of the wells.

Issuance of a notice of abandonment which has the effect of triggering a deemed election to take over the well absent a response within thirty days constitutes the exercise of a "right and remedy" within the meaning of the stay provision of the Order (at paras 17 – 19). Since the notices were issued without the consent of the Receiver and without leave of the Court they were of no effect (at para 9). This was not a case in which the Court should lift the stay and grant leave *nunc pro tunc* since the effect of such an Order would be shift the entire costs of abandonment to Sterling (at para 20). Baytex is at liberty to re-issue the notices of abandonment since the Receiver had consented to same (at para 20). While there was some suggestion (at para 18) that abandonment might be cheaper than fulfilling the requirements of the Energy Resources Conservation Board in relation to suspended wells, the Court emphasised that Baytex was relying on its contractual rights to have Sterling assume the entire responsibility for the wells rather than any provision in the *Oil and Gas Conservation Act*, RSA 2000, c O-6 (*OGCA*). Indeed, section 30 of the *OGCA* contemplates that well suspension costs, abandonment costs and reclamation costs are to be paid by the working interest participants in accordance with their proportionate share in the well.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

October 25, 2012

Natural Gas Storage Rights in Ontario: Questions of Jurisdiction and Interpretation

Written by: Nigel Bankes

Cases Commented On: *Tribute Resources v 2195002 Ontario Inc*, 2012 ONSC 25 (on the jurisdictional issue); *2195002 Ontario Inc v Tribute Resources Inc*, 2012 ONSC 5412 (on the interpretation issues)

These two decisions represent one example of the efforts of Ontario landowners who claim ownership of natural gas storage rights by virtue of owning the rights to petroleum and natural gas to assert those rights against working interest owners who claim to have acquired storage rights by various old instruments including petroleum and natural gas leases, unitization arrangements, and, in some cases, specific gas storage leases. The cases are part of a broader litigation strategy in which storage owners are trying to negotiate more favourable economic terms that afford them the right to participate in the value that the storage represents to Ontario utilities and generators.

In this case the landowner, McKinley Farms Ltd, is trying to do this by entering into a storage agreement with a related corporation, Ontario 219. I assume, but I do not know, that the 219 storage agreement incorporates economic terms that are more favourable to the lessor than is typical in the Ontario storage business. I have written about those terms with co-author Julia Gaunce here. Having entered into this agreement, Ontario 219 brought this application questioning whether the old rights claimed by Tribute through earlier agreements with McKinley Farms (specifically an oil and gas lease as modified by a unitization agreement) really does continue to afford Tribute the right to store natural gas. In particular, Ontario 219 sought: (1) a declaration that there are "no gas sands" in, on or under the lands owned by McKinley; (2) a declaration that the Tribute Oil and Gas Lease does not permit Tribute to store gas in or under McKinley lands; and, (3) a declaration that the 219 Ontario Gas Storage Lease permits the injection into, storage under, and withdrawal of, stored gas from beneath the McKinley lands.

This was not the first time around on these issues at least for McKinley and Tribute (see *Tribute Resources v McKinley Farms*, 2010 ONCA 392). I have discussed that earlier litigation in a previous ABlawg post here. The crucial point for present purposes is that the Ontario Court of Appeal in that earlier case held that Tribute's gas storage lease had terminated although the rights that it had under its oil and gas lease (as varied by the unitization agreement) continued.

In the current round, Tribute first raised a jurisdictional objection which had succeeded in another gas storage case: see my previous ABlawg post on *Snopko v Union Gas Ltd*, 2010 ONCA 248 here. Tribute's argument was that all of these issues fell under the exclusive jurisdiction of the Ontario Energy Board (OEB).

This post discusses the preliminary jurisdictional point and then the decision on the merits.

The Question of Jurisdiction

Timing seems to be everything in thinking about the jurisdictional question and the ratio of the *Snopko* case and thus it is important to appreciate that while Tribute applied to the OEB to have it make an order designating an area including the McKinley farm lands as a designated gas storage area in September 2009 (subsequently withdrawn and renewed in 2011) the OEB stayed these applications pending the determination of both the earlier dispute between McKinley and Tribute and the present matter.

Justice Bryant rejected Tribute's jurisdictional arguments. In Bryant's view Ontario 219's application was simply an application to interpret various leases. The subject matter of this application did not fall within the language of sections 36.1, 38(1), 38(3) or 40(1) of the *Ontario Energy Board Act, 1998* (*OEBA*) (quoted below). Thus the Superior Court has jurisdiction in respect of these matters and these matters are not within the exclusive jurisdiction of the OEB since the Board has not made a relevant storage designation order under the *OEBA*.

Justice Bryant's rejection of the jurisdictional attack paved the way for Ontario 219's main application.

The Main Application

In its main application Ontario 219 contested the scope of Tribute's extant storage rights. In order to understand this issue it is important to appreciate that Tribute relied on three documents as the potential source of storage rights: (1) its original oil and gas lease (OGL) relating to the property, (2) the amendment of the OGL by a unitization agreement, and (3) a gas storage lease (GSL, but understanding that the Ontario Court of Appeal had already determined in previous proceedings, *supra*, that the GSL was no longer in force).

The Documents

The Tribute OGL provided that:

> That the Land Owner…does hereby grant, demise, and lease to Operator…[the oil and gas rights] …and Land Owner also leases to Operator the exclusive right to drill for, produce, *store*, treat, transport and remove by any method all oil and gas found in or under the said lands, *to store in any gas sands on the premises and withdraw therefrom gas originally produced from other lands…* [emphasis added].
>
> If, at any time prior to the termination of this lease, the Operator should decide to utilize *any underlying productive gas sand as a storage reservoir for gas originally produced from other lands,* Operator agrees to notify Land Owner of such utilization, and thenceforth to pay Land Owner double the herein specified acreage rental amount as full compensation for the storage rights herein granted and in lieu of all delay rental… [emphasis added].

The Tribute OGL was subsequently amended by a unit operation agreement which provided in part as follows:

> 12. If, at any time prior to the termination of this Agreement, the Lessee should decide to utilize *the underlying productive gas sand as a storage reservoir* [emphasis added] for

> gas originally produced from other lands, the Lessee agrees to notify the Lessor of such utilization, and thenceforth to pay Lessor double the herein specified acreage rental amount as full compensation for the storage rights herein granted and in lieu of all delay rental in event there is a productive well or wells on these lands at the date of said notification *the Lessee shall not commence utilization of the lands as a storage reservoir without first entering into an agreement with the Lessor to settle the value of the Lessor's royalty…* [emphasis added].
>
> 16. Excepting as herein hereby expressly modified or amended, *the said lease shall continue in all respects in full force and effect for so long as therein provided, and the same as so amended or modified is ratified and confirmed…* [emphasis added].

The Tribute GSL (found by the Ontario Court of Appeal to have terminated in *Tribute Resources Inc. v McKinley Farms Ltd*., 2010 ONCA 392 (CanLII), 2010 ONCA 392, [2010] OJ No 2293) provided that:

> The Lessor doth hereby demise and lease unto the Lessee, its successors and assigns all and singular the said lands save and except the surface rights thereto, save as hereinafter provided, (hereinafter called "the demised lands"), to be held by the Lessee, subject to the oil and gas lease, as tenant for a term of Ten (10) years from the date hereof, subject to renewal as hereinafter provided, for the purpose of injecting, storing and withdrawing gas, natural and/or artificial, (hereinafter collectively referred to as "gas") within or from the demised lands:
>
> 16. *Subject to its rights, if any, under the oil and gas lease*, the Lessee shall not inject gas into the demised lands under the provisions hereof unless… [emphasis added].
>
> 21. This Agreement expresses and constitutes the entire agreement between the Parties, and no implied covenant or liability of any kind is created or shall arise by reason of these present or anything herein contained.

The Schedule to the GSL stipulated that "all provisions in this schedule shall be additional and shall be paramount with any of the terms contained in the original agreement." The evidence of Ontario 209 was to the effect that the storage target on the McKinley lands was a Silurian Pinnacle Reef and not a sand. Reefs are composed or carbonates while sands are unconsolidated detrital rock fragments. The pinnacle reef rocks comprise anhydrites and carbonates.

The Decision on the Main Application

Justice Rady concluded that Tribute had no right to store gas under the terms of its OGL. It was not necessary to determine how the term "gas sands" should be interpreted and neither was it necessary to determine whether that term was ambiguous. This was because the parties had a shared intention that the GSL was to replace the rights that had been acquired under the earlier OGL as modified by the unit operating agreement. This intention was revealed by the entire agreement clause in the GSL which must mean that all matters pertaining to storage are contained in the GSL. This was reinforced by the Schedule which made it clear that the parties intended the storage lease to prevail, at least with respect to those matters dealt with in the Schedule.

The unit agreement also supported this interpretation since it provided that the lessee should not begin using the lands for storage purposes until a further agreement was reached on the lessor's royalty entitlement. That agreement also expressly provided that the oil and gas lease was to remain in full force and effect except as modified by it and there was no similar language in the GSL.

The subsequent conduct of the parties in executing a specific storage lease suggested that they considered that the OGL dealt primarily with drilling and extraction rights and did not adequately provide for storage. The OGL did not provide for issues such as compensation for crop damage while the GSL dealt with that issue and provided a specific right to install compressors, a mechanism for computing and paying for the residual gas in the pool and an additional acreage rental, none of which were dealt with in the OGL. The GSL was more than just a supplement to the earlier OGL and provided strong objective evidence that the parties intended the GSL to provide for all of the contractual rights and obligations governing storage and that it was intended to replace the earlier OGL in relation to storage issues. It was also significant that Tribute wished to have McKinley execute a storage lease before it applied to the Ontario Energy Board for a gas storage designation order. This suggested that Tribute was not confident that it had continuing storage rights pursuant to the OGL.

Commentary

The principal issue in all of these cases is the extent to which old agreements principally directed at oil and gas production rather than storage should continue to govern the economic terms and conditions of storage today. Up until now Ontario gas utilities have been very successful in insisting that these issues are governed by existing contractual arrangements and furthermore that the courts should leave these issues to the experts, in this case the Ontario Energy Board. This is the first decision to open a chink in the armour of *pacta sunt servanda* and the privative clauses protecting the specialized jurisdiction of the OEB. The case will almost certainly be appealed and will be worth watching for a number of reasons including for what it might tell us of the relationship between the ordinary courts and the specialized jurisdiction of energy tribunals (as to which see my presentation to the CBA's Administrative Law sub-section, Alberta (South) in May 2012 here).

Selected Provisions of the Ontario Energy Board Act

Gas storage areas

36.1 (1) The Board may by order,

(a) designate an area as a gas storage area for the purposes of this Act; or

(b) amend or revoke a designation made under clause (a).

Authority to store

38. (1) The Board by order may authorize a person to inject gas into, store gas in and remove gas from a designated gas storage area, and to enter into and upon the land in the area and use the land for that purpose.

Right to compensation

(2) Subject to any agreement with respect thereto, the person authorized by an order under subsection (1),

(a) shall make to the owners of any gas or oil rights or of any right to store gas in the area just and equitable compensation in respect of the gas or oil rights or the right to store gas; and

(b) shall make to the owner of any land in the area just and equitable compensation for any damage necessarily resulting from the exercise of the authority given by the order.

Determination of amount of compensation

(3) No action or other proceeding lies in respect of compensation payable under this section and, failing agreement, the amount shall be determined by the Board.

Appeal

(4) An appeal within the meaning of section 31 of the *Expropriations Act* lies from a determination of the Board under subsection (3) to the Divisional Court, in which case that section applies and section 33 of this Act does not apply.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

cc BY NC ND

September 27, 2013

Ontario Court of Appeal Confirms that Courts Have Some Residual Jurisdiction Over Natural Gas Storage Matters

Written by: Nigel Bankes

Case Commented On: *2195002 Ontario Inc v Tribute Resources Inc*, 2013 ONCA 576

In this decision the Ontario Court of Appeal confirmed the conclusion reached in two separate applications before the Superior Court of Justice in Ontario related to a gas storage matter. For my post on these two decisions see here.

One decision, *Tribute Resources v 2195002 Ontario Inc*, 2012 ONSC 25 dealt with the jurisdiction of the Superior Court to consider the matter, the argument being that all gas storage issues should be litigated before the Ontario Energy Board (OEB) because of the preclusive clauses in the *Ontario Energy Board Act*, SO 1998, c.15 and the decision of the Ontario Court of Appeal in *Snopko v Union Gas Ltd*, 2010 ONCA 248, the subject of an earlier post here. A second decision, that of Justice Helen Rady in *21955002 Ontario Inc v Tribute Resources Inc* 2012 ONSC 5412, dealt with the substantive question of whether Tribute could claim storage rights on the basis of an oil and gas lease and a unitization agreement or whether its rights were confined to such rights as it held under a gas storage lease which lease the Ontario Court of Appeal in an earlier action held to have expired: *Tribute Resources v McKinley Farms*, 2010 ONCA 392, also the subject of a previous ABlawg post here.

The only decision under appeal here was that of Justice Helen Rady in 2012 ONSC 5412.

In its decision the Ontario Court of Appeal agreed with Justice Rady's main conclusion on the substantive and interpretive questions in 2012 ONSC 5412 to the effect that Tribute's gas storage lease (GSL) had been intended by the parties to completely replace any storage rights that Tribute might have been able to claim under the earlier agreements (the oil and gas lease and the unitization agreement) and thus, with the expiry of the GSL, the only possible conclusion was that Tribute's storage rights had come to an end. In reaching that conclusion the Court of Appeal relied on many of the same grounds as had Justice Rady including the entire agreement clause in the GSL, and the greater specificity of the GSL which made it clear that storage matters were to be governed exclusively by the GSL and not the earlier agreements. The Court of Appeal also relied upon the fact that the different agreements offered different ways for determining the payment for gas storage rights (at para 54): "this difference in the payment provisions makes it clear that the 1998 Tribute Gas Storage Lease was intended to replace the earlier agreements and not merely to supplement them. Because of the difference in the payment provisions, the two sets of documents could not co-exist."

The decision on the jurisdictional issue 2012 ONSC 25 authored by Justice Bryant was not appealed (at para 27 of this decision) and that matter was therefore not technically before the Court of Appeal in this decision. But 219 Ltd still ran a variant of that application taking the

position that the Court of Appeal had no jurisdiction to consider the appeal since between Justice Rady's decision (rendered October 18, 2012) and the matter coming on before the Court of Appeal, the OEB, on the application of Tribute, had made an order designating the subject lands as a gas storage area under the Act (however the OEB stayed the associated compensation matters pending the outcome of this litigation). The Court of Appeal rejected that argument concluding that its jurisdiction was founded upon Justice Bryant's decision and when that decision was made there was no gas storage order in place. The Court commented more extensively as follows:

> [28] The jurisdiction of this court to entertain this appeal derives from s. 6 of the *Courts of Justice Act*, R.S.O. 1990, c. C. 43 (the "CJA"). Under s. 6(1)(b) of the CJA, this court has jurisdiction to entertain an appeal from the application judge's decision because it is a final order of a Superior Court judge.
>
> [29] The parties agree that the application judge had jurisdiction to render her judgment interpreting the relevant contractual documents. Her judgment is a final order and nothing in s. 38(3) of the Energy Act ousts this court's jurisdiction to entertain an appeal under s. 6(1)(b) of the CJA. Neither the decision of the application judge, nor this decision, address compensation under the Energy Act. The order of the OEB made some four months after the decision of the application judge cannot turn what was an order interpreting contractual rights into an order for compensation under the Energy Act.
>
> [30] The questions of what, if any, effect this court's decision will have on the OEB's determination of the compensation issues now outstanding under the Energy Act and whether this appeal may now be moot are different issues than the jurisdictional issue raised by 219 Ontario.
>
> [31] The fact that this court has jurisdiction to entertain an appeal from the application judge's decision does not determine the question of the effect, if any, of this court's decision on the compensation issues under the Energy Act.
>
> [32] We make no comment on that subject, which will be a matter for the OEB to determine.

Thus, at least so long as there is no OEB designated gas storage area order in effect in relation to the subject lands at the time that a matter is heard by the ordinary courts, the ordinary courts of justice have the jurisdiction to determine the existence, validity and interpretation of natural gas storage rights arising by way of contract between the parties.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

October 26, 2012

Manitoba Decision on the Assignment of a Royalty Interest

Written by: Nigel Bankes

Case Commented On: *Campion et al v Radomski et al*, 2012 MBQB 267

In this case the beneficiaries of the Milliken estate (the beneficiaries) sought to ignore an assignment of a royalty interest that Milliken had executed during his life in favour of the Manning interests. The parties entitled to the Manning royalty interest sued to enforce that assignment and in this case the court dismissed an application by the beneficiaries (the defendants) for summary judgement.

The Facts

Milliken, as the registered owner of the mines and minerals estate, entered into a petroleum and natural gas lease with California Standard (CS) in 1950. One of the provisions of the lease (cl. 24) provided that the Lessor could only assign its entire interest in the lease and that CS was not required to recognize a partial assignment. In 1951 Milliken entered into an "Assignment Part of Royalty (Petroleum)" agreement with the Manning Group which provided in part as follows:

> 1. … the Assignor doeth hereby assign, transfer, convey, grant and set over unto the Assignee, his heirs, administrators, executors and assigns, an undivided six and one quarter per cent of all the productions of the leased substances or any of them, produced, saved and marketed from the said lands hereinbefore described, calculated and payable as set out and provided for in the said lease agreement make between the Assignor herein as Lessor and the California Standard Company as Lessee and dated the 21st day of September A. D. 1950, as aforesaid.
>
> 3. The Assignor covenants and agrees with the Assignee that this assignment shall not only cover and include the percentage of the production of the leased substances herein assigned and set over unto the Assignee but shall also cover, include and apply to all productions of the leased substances or any of them produced, saved and marketed from the said lands under and by virtue of all leases to be entered into between the Assignor and any other person … in the future.
>
> 4. In the event the said lease agreement hereinbefore mentioned is cancelled, terminated, surrendered or lapses or is determined for any cause whatsoever, the Assignor shall forthwith use his best endeavours to enter into a new lease covering the leased substances: the terms, conditions and stipulations of the new lease to be first agreed upon between the parties hereto, two of the terms of which lease agreement shall be that the royalty payable to the Assignor under the said lease shall be divided as to fifty per cent to the Assignor and fifty per cent to the Assignee, and that the new Lessee shall at all times observe the terms and conditions and stipulations of this agreement and if the Lessee fails to perform, drill for, win or get the leased substances from the said lands according to the

> terms, conditions and stipulations of the new lease so that the same is cancelled by either party, or lapses or is terminated, the Assignor shall enter into a new lease agreement with a new person, partnership or corporation according to the terms, conditions and stipulations hereinbefore set out and so on until all the leased substances which exist within, upon or under the said lands are obtained and recovered.
>
> 6. This Agreement and everything herein contained shall enure to the benefit of and be binding upon the parties hereto, their heirs, executors, administrators and assigns respectively [emphasis supplied].

The Manning Group registered a caveat in relation to its interest. CS surrendered its lease in 1959 and in 2006 the beneficiaries entered into a petroleum and natural gas lease with Tundra reserving a 15% royalty. Tundra obtained production and has since paid all of the royalty to the beneficiaries. The plaintiffs, the heirs and assigns of the Manning Group, brought this action seeking a declaration that the Tundra lease was unenforceable against them, an accounting in relation to all oil and gas produced from the lands, and an injunction. The beneficiaries in turn brought this application for summary judgement and for an order dismissing the statement of claim. In support of its application, the beneficiaries contended that the Manning agreement did not transfer an interest in land but only provided rights in personam.

The Decision

Justice Menzies dismissed the application for summary judgement. The Court reasoned that upon the grant of the CS lease Milliken retained the right of reversion in the minerals and a fee simple interest in the minerals in situ. Examination of the Manning agreement confirmed that Milliken intended to transfer to the Manning Group an interest in the substances in situ. The parties to the agreement intended to share a right in common to participate in the development of the affected minerals for so long as those substances existed in the property. Therefore, this was not a case in which the plaintiffs would stand no reasonable prospect of success. Similarly, clause 24 of the lease could only bind the parties to the lease. The beneficiaries could not rely on clause 24 to avoid obligations that Milliken had assumed in relation to the Manning Group and the clause did not invalidate the assignment to the Manning Group.

Commentary

The decision to dismiss this motion to strike is surely correct, whether on the grounds given or simply on the basis that the beneficiaries of the estate are bound by the contractual undertakings of the testator since they are simply volunteers. The Court is also correct in concluding that a provision in a lease in which the lessee stipulates that it does not have to recognize an assignment of less than the entire interest cannot render void any such an assignment – it can only create rights and obligations as between the parties.

Perhaps then this case will go to trial, or perhaps it is more likely that the parties will settle. Two further points. First, the language of the assignment is unusual. While one of the common forms of gross royalty trust agreement did provide for an assignment of an undivided interest in the lessor's estate, this particular agreement does not go that far. It does not create the relationship of tenants in common as between the assignor and the assignee in the mineral estate. This is

because the assignor does not assign his corporeal estate in the minerals. Instead, Milliken merely assigns an undivided interest in "all the productions of the leased substances or any of them." In the GRTA test cases litigation for example (sub. nom. *Scurry-Rainbow Oil Ltd v Galloway Estate*, [1995] 1 WWR 316) the Fletcher property GRTA provided for an assignment of "the full undivided" 12.5% interest "in and to the said lands" and the Noble property GRTA provided for a grant of "an undivided gross 12 ½% interest in all the substances in, on or under the said lands". Both grants go beyond the scope of the grant in this case. Thus, this may still be an assignment of an interest in land, but it is not quite as obvious as Justice Menzies suggests and it certainly does not create a community of interest in the mineral estate as Justice Menzies hints at.

Second, the relief sought is interesting. The plaintiffs claim, *inter alia*, that the lease is unenforceable against the plaintiff's interest and an accounting of all of the production from the lands. Both elements of this claim seem problematic.

The first claim is problematic since the Manning interests do not have an independent right to lease the lands or any undivided interest in the lands since they are not tenants in common of an undivided interest in the fee estate (see above). Furthermore, even if they were, each tenant in common has the right to lease the minerals and its lessee is entitled to drill and produce (subject to complying with applicable oil and gas conservation rules) subject only to a duty to account for producing somebody else's share i.e. even on that analysis, the Tundra lease would not be unenforceable.

The second claim is problematic because the accounting must surely be limited to Manning's share under the terms of the assignment. True, it seems that the beneficiaries have breached the Manning Agreement by failing to consult on the terms of the Tundra lease, but that only gives rise to an action in damages (and what would be the damages?) It doesn't make the lease void or provide access to an accounting remedy as to the *entirety* of the production.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

Manitoba Decision on the Assignment of a Royalty Interest

Comments:

Joe Rayback says:

February 11, 2013 at 11:05am

> nice blog………………..thanks Nigel Bankes

A. Robbins says:

July 7, 2014 at 8:25am

> I am interested in your comment that ". . . the Manning interests do not have an independent right to lease the lands . . . ". If I understand this correctly, by virtue of Clause 4 of the Assignment Part of Royalty (Petroleum) agreement, the Milliken interests were the ones who had the right to enter into a lease (and collect the signing bonus), and that the Manning interests were entitled to receive royalties on production and nothing more. Is this a correct interpretation? Thanks.

Nigel Bankes says:

July 7, 2014 at 11:47am

> The short answer is yes, assuming that I am correct in my contention in the commentary section of the post that cl. 1 of the assignment agreement does not make the Manning interests co-owners of the corporeal estate. It follows that I emphasise cl. 1 rather than clause 4; cl. 4 is simply the natural corollary of cl. 1.
>
> I think my contention is correct because the undivided interest referred to in cl.1 is an undivided interest in production not an undivided interest in the fee simple estate.
>
> Nigel

E. Repeta says:

July 17, 2014 at 1:19pm

> Hi Nigel,
>
> Regarding your response to the Robbins post: Although there is no mention of what the

Manitoba Land Titles Office records show, if the records do state that the Milliken interests are registered owners of "All mines and minerals . . . EXC an undivided XX interest in all Petroleum, Natural Gas and related hydrocarbons . . ." for the property of interest and if the records for the Manning interests for the same property show "An undivided XX interest in all Petroleum, Natural Gas and related hydrocarbons . . .", would this not indicate that because Milliken retained ownership of the mines & minerals for the land (except for the interest in production assigned by the Assignment of Royalty document),that the Manning interests were not made co-owners of the corporal mineral estate for these said lands?

Thanks.

E. Repeta

Nigel Bankes says:

July 25, 2014 at 12:40pm

Thanks for the inquiry based on some assumptions as to the state of title in the Manitoba LTO.

My response is as follows.

1. We know that the Manning interests protected their interest (whatever it was) by filing a caveat. The judgement does not give us the terms of the caveat. The fact that the Manning interests only filed a caveat suggests that they did not have in their possession a transfer of an undivided interest in the fee simple interest in the mines and minerals in registerable form.

2. A caveat cannot improve or perfect the underlying interest; thus, even if the caveat claimed an undivided interest in the corporeal interest in the mineral estate the caveat could not make it so if that were not supported by the underlying contractual interest.

3. If the Manning interest were indeed somehow registered (and not just caveated) as to an undivided interest in the corporeal estate such a declaration would redound to the benefit of a purchaser for value on the faith of the register but might not be conclusive as between the original parties since the Milliken interests might be able to have the registration rectified to conform to the agreement between the parties: Re Pylypow et al and the Public Trustee (1973), 40 DLR (3d) 313 (Alta. CA). Much might depend on the application of the doctrine of merger to the contract and the registerable transfer.

Nigel

February 20, 2013

When is a Lease Issued "In Lieu" of an Existing Lease?

Written by: Nigel Bankes

Case Commented On: *Canadian Natural Resources Limited v Jensen Resources Ltd*, 2012 ABCA 786

In the early 1980s the Government of Alberta decided to make a clearer distinction in its tenure regime between grants of conventional petroleum and natural gas (PNG) rights and grants of oil sands rights. In implementing this policy the province went so far as to redefine the rights contained in existing Crown PNG leases. But in return, it allowed the affected PNG lessees to apply for a form of oil sands tenure for the rights that had been excluded from the PNG leases. That's what happened in this case and the issue was whether Jensen's gross overriding royalty (GOR) which clearly applied to the PNG leases also carried over to the oil sands rights. Justice Jo'Anne Strekaf held that it did.

Facts

Jensen Resources claimed a GOR on oil sands production in three sections of land (sections 1, 4 and 32). The GOR agreement provided (at para 5) that

> The [GOR] interest herein conveyed shall attach to and encumber the Petroleum and Natural Gas Lease above described, and any renewals or extensions thereof, or any new leases which may be executed in lieu thereof, subject to the terms of this agreement.

At the time that the GORs were granted (1978 – 1980), the grantor (Kissinger) held three separate Crown PNG leases for the three sections which included oil sands rights. Subsequently, with the passage of the *Oil Sands Conservation Act* (now RSA 2000, c O-7) the Energy Resources Conservation Board issued Oil Sands Area Order 3 (1984) which "deemed the hydrocarbon substance, with the exception of natural gas and coal, found in certain geological zones from the top of the Mannville formation through to the base of the Woodbend formation in the Athabasca, Cold Lake, and Peace River areas" to be oil sands. This Order included the lands under the three PNG Leases and had the effect of reducing the rights held under the three PNG Leases (at para 39). A contemporaneous Information Letter (IL 84 – 15) issued by Alberta Energy and Natural Resources contemplated that holders of Crown PNG leases that were affected by Oil Sands Area Orders would be able to apply (at para 40) for "a substitute oil sand agreement … to the whole or any part of the location upon completion of a well located on the location… where the "hydrocarbon substance" is able, in its naturally occurring viscous state, to flow to a well and has sustained recoverability to the satisfaction of the minister." Kissinger's successors in interest took advantage of this policy and as a result acquired either an oil sands lease (OSL) (sections 1 and 4) or an oil sands prospecting permit (OSPP) for lands that included section 32. Ultimately an OSL was also issued for the section 32 lands. The OSLs all became vested in CNRL.

Oil has been produced from section 4 since May 1997 and from section 1 since December 2003. Neither CNRL nor its predecessors have paid any royalties to Jensen in respect of such production. Oil has been produced from section 32 lands since May 1999. CNRL and its predecessors have paid royalty on the section 32 production. In all of these cases production was obtained by conventional means albeit under the terms of the OSLs rather than the PNG leases. Jensen had no actual knowledge of production from the section 1 and 4 lands until 2007.

By originating notice Jensen sought a declaration that it was entitled to a royalty on the OSLs pertaining to the three sections of land and an accounting from CNRL for all royalties not paid since production commenced. CNRL in turn commenced an action claiming that Jensen had no royalty interest in any of the producing properties and sought to recover all royalties paid in relation to the section 32 lands.

Decision

Justice Jo'Anne Strekaf concluded that Jensen's GOR applies to the sections 1 and 4 OSL and to the section 32 OSL on the basis that the OSLs were issued in place of the PNG Leases with respect to the Mannville zone for those sections. CNRL's action was dismissed. While an applicant for oil sands rights needed to complete additional steps and while the OSLs were not automatically issued to the PNG leaseholders and the issuance of the oil sands rights was not expressly stated to be "in substitution" for the removal of the Mannville zone from the PNG leases resulting from the issuance of the Oil Sands Area Order 3, that (at para 55) was the substance of the arrangement.

Jensen's recovery was subject to the 10 year limitation period of section 3(1)(b) of the *Limitations Act* (RSA 2000, c L-12). Jensen was not precluded from recovery by the discoverability rules of section 3(1)(a) of the Act. In particular, Jensen was entitled to expect that the royalty payor would honour its obligation (at para 68). There was no clear information that the royalty payments were improper. Absent that, a royalty interest holder should not be expected to be required to take positive steps to ensure that they are being correctly paid.

Commentary

This seems to be an appropriate result. The original leases conferred rights to hydrocarbons in the Mannville which were removed as a result of Oil Sands Area Order No. 3. The clear policy of the government was to ensure that PNG lessees obtained substitutionary oil sands rights if they wished to, whether in the form of a permit or a lease. The relevant IL expressly referred to such substitutionary rights being issued under what was then section 8(1)(f) of the *Mines and Minerals Act* (RSA 1980, c M-15) which provided that:

> 8(1) The Minister may:
>
> (f) if he consider that the circumstances warrant it, agree with a lessee to grant an agreement to the lessee in substitution for an agreement held by the lessee.

Thus, as a matter of contract, it seems clear that, as between the original parties to the GOR, the grantor of the GOR was contractually obliged to ensure that the GOR continued on as against the new oil sands tenures which now conferred the rights that were originally contained in the PNG leases. But the parties to this litigation were not the same parties. The issue is easy on the benefit side of the equation since the benefit of the GOR was expressly assigned to Jensen Resources Ltd. But what of the burden?

There is little if any discussion of this in the decision and unfortunately Justice Strekaf does not give us a complete picture of the chain of title. There is some discussion of the chain at paragraphs 14, 15 and 20 which suggests that some of the early changes in ownership were the result of corporate amalgamations in which case existing contractual obligations would continue. But it is not clear that the subsequent changes in ownership can be explained in the same way. CNRL, for example, acquired its interests in the OSLs "through its acquisition of assets from Petrovera Resources Inc" (at paras 15 and 21) and that sounds more like acquisition by way of a purchase and sale agreement than it does by way of a corporate amalgamation. And if that is the case then it would seem that Jensen has an additional challenge, at least in relation to the sections 1 and 4 lands where CNRL had never paid a royalty.

To succeed Jensen must be able to make the burden of the positive promise (to apply the royalty to the new agreement) run against CNRL. And to do that it must show that that promise is a legal or equitable interest in land that binds CNRL. Since the lands were Crown lands the interests would be unregisterable and so the interests in land (if established) would bind automatically (if legal) or with notice (if equitable). There is no discussion of this point in the case. Perhaps counsel was prepared to concede that the proprietary language of the GOR was so obvious that the GOR clearly established the intention of the parties to create this GOR as an interest in land as laid down in *Bank of Montreal v Dynex Petroleums Ltd,* [2002] 1 SCR 146. But is that enough? Or does Jensen also need to show that the additional promise to attach the GOR to the new lease also qualifies as an interest in land? If so that would be much more challenging. It may also be that the decision can be explained (and there is a strong hint of this at para 71 referring to the Agreed State of Facts) on the basis that CNRL, because of contractual commitments made to a predecessor in title, simply conceded that it would be liable if the original contracting parties would have been liable.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

December 2, 2013

Limitations Issues in Oil and Gas Royalty Litigation

Written by: Nigel Bankes

Case Commented On: *Canadian Natural Resources Limited v Jensen Resources Ltd*, 2013 ABQB 399

This case involves a geologist's gross overriding royalty (GORR). The principal issue at trial (see earlier post here) was the question of whether or not the royalty continued as against the property in question when the Crown issued oil sands leases for the oil sands rights in place of the earlier petroleum natural gas leases which were in force when the royalties crystallized. The trial judge held that the royalty did continue against these new leases and the Court of Appeal has confirmed that part of the award.

The Court of Appeal has varied the judgment at trial in relation to the limitations issue. While Justice Strekaf at trial held that the two year limitation period did not begin to run until the plaintiff had clear information to the effect that the defendant was not paying royalty on the encumbered lands, the Court of Appeal in an unanimous memorandum of judgment concluded that that was not the relevant test and that Jensen (through its principal, Gowertz, the geologist) ought to have known long before that that the royalty was payable. Accordingly, Jensen could only recover the unpaid royalty back to two years before its Originating Notice was issued.

In reaching the conclusion that she did Justice Strekaf at trial had relied heavily on the judgment of the Court of Appeal in *Meek (Trustee of) v San Juan Resources Inc.*, 2005 ABCA 448 where the Court held that:

> [33] …A royalty interest holder is entitled to expect the royalty payor to honour its obligations. Absent clear information to show improper payment, royalty interest holders are not obliged to take positive steps aimed at ensuring that they are being correctly paid…

In this case the Court of Appeal emphasized the importance of returning to the language of the statute and the facts. Since discoverability relates to issues of fact and not questions of law the crucial question was when Gowertz ought to have known that there was production on the sections 1 and 4 lands as well as the section 32 lands (on which Jensen *was* receiving royalties). Noting that Gowertz became aware that there was oil sands production on the section 32 lands sometime between 1997 and 1999, and given Gowertz's experience and knowledge that heavy oil production was increasing in the Cold Lake area, a reasonable person in his position would have made inquiries as to whether there was also production from the other two sections especially since these lands were reasonably proximate to the section 32 lands. By his own admission Gowertz failed to make those inquiries. The Court concluded as follows:

> [48] On this record, Gowertz had sufficient information to put him on inquiry sometime after 1999. If he had made reasonable inquiries at that time, he would have discovered

that there was already oil production on section 4, and it would have alerted him to the possibility of future production on section 1. The respondent ought to have known, in this time frame, that it had a claim for royalties against the holder of the oil sands leases. The precise date need not be ascertained, because this is well before the limitation cutoff date, two years before the issuing of the Originating Notice. In the result, the respondent is entitled to an accounting for royalties on oil production on sections 1 and 4, but only from and after September 18, 2007.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

Limitations Issues in Oil and Gas Royalty Litigation

Comments:

Jay Jackson says:

January 5, 2014 at 6:27am

> I see. So it is the responsibility of the payor to see to it that the royalty payments have been met despite prior notice or lack of information because it was already stated in the contract based on laws.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

cc BY NC ND

March 22, 2013

A Farmee that Spuds in the Test Well has the Right to a Default Notice

Written by: Nigel Bankes

Case Commented On: *EOG Resources Canada v Unconventional Gas Resources Canada Operating, Inc*, 2013 ABQB 105

This decision interprets the default clause (Article 13) of the Canadian Association of Petroleum Landmen's (CAPL) Farmout and Royalty Procedure. It confirms that there is no automatic termination of the farmee's right to earn provided that the farmee has spudded in the earning well; the farmee is entitled to proper notice of default and the opportunity to rectify that default.

The Facts

UGR as farmor entered into a Farmin and Option Agreement (the head agreement) with EOG under which EOG was to earn a 75% interest in certain lands in return for drilling to completion a horizontal well at its sole cost, risk and expense (the test well). The head agreement incorporated by reference the CAPL Farmout and Royalty Procedure and the CAPL Operating Procedure (1990). EOG spudded in and drilled the test well and was engaged in completion operations between March 9, 2011 and March 20, 2011 but was required to leave the land during a sensitive period for woodland caribou. Some subsequent discussions between the parties about having EOG participate in the drilling of an option well on adjacent lands led to an amendment to the head agreement. The option well was never drilled and the test well was never completed before UGR began to allege that EOG was in breach, ultimately taking the view in correspondence and in the pleadings that as a result of EOG's breach EOG had lost the right to earn under the head agreement. UGR conceded that if EOG was entitled to notice of default and the opportunity to correct that default then UGR had not provided adequate notice.

EOG sought a declaration that its right to earn under the head agreement in respect of the test well remained valid and subsisting. The Court proceeded on the assumption that EOG had failed to continuously conduct operations to complete the test well (at para 27 and see below).

The Decision

Master Judith Hanebury concluded that EOG was entitled to notice of default. Article 13 of the Farmout and Royalty Procedure governed the issue. Article 13 deals with a number of different circumstances: (1) a farmee that fails to spud in the test well by the prescribed date loses its right to earn; (2) a farmee that fails to honour other obligations is entitled to notice before losing its interest, and; (3) a farmee that has earned an interest is entitled to the protection of that interest unless its default is in relation to a condition subsequent (at para 47). This situation fell within the second category and accordingly EOG was entitled to notice and the opportunity to cure the default.

Commentary

There were really two issues in this case: first, was EOG in breach of its obligation to continuously conduct operations to complete the well, and second, if it was in breach did such breach automatically terminate the farmee's right to earn or was it entitled to notice of default and the opportunity to cure that default. The first issue is evidently a mixed question of fact and law and Master Hanebury was perhaps surprised to have the matter before her in chambers rather than the subject matter of a trial. In response she took the prudent course of action and left that matter for another day, noting that the parties had not provided evidence of practice in the industry relating to continuous operations and therefore concluding (at para 27) that:

> Without this law and information the Court risks making a decision that is not sensitive to the commercial realities of the industry and is, simply, a bad precedent. Therefore, for the purposes of deciding the next question I will assume, without deciding, that a failure to continuously conduct operations to complete the well occurred.

Article 13 of the CAPL farmout and royalty procedure deals with default issues under that agreement and the head agreement. Clause 1301 is headed "farmor's default remedies." Clause A deals with the farmee's failure to spud the test well in which case the "Farmee's right to conduct operations hereunder terminates." This is all subject to the application of the force majeure provisions of the agreement. Clause B deals with the failure to make overriding royalty payments. Clause C deals with any other defaults under the head agreement or the procedure and specifically provides for the farmor to provide the farmee with a notice "stating the nature of the default." The farmee must take steps to remedy the default within 30 days failing which the Farmor, may by notice "terminate all or any portion of the interest of the Farmee acquired in the Farmout Lands …." Clause D provides that termination will not apply to any Working Interest already earned by the farmee thereby making a distinction between this defined term and the more generic term "interest" as used in Clause C. It is perhaps this distinction that leads Master Hanebury to speculate (at paras 37 and 45) that while EOG has earned a vested interest in the lands it does have "a contingent or conditional interest in the lands."

In sum, the plain language of the agreement suggests precisely the distinction that Master Hanebury made in her judgement: the matter is covered by Clause C. UGR seems to have tried to get around that interpretation of the agreement by relying on two lines of authority. One line of authority comes out of the freehold oil and gas leases. These leases contemplate that they may terminate automatically in some cases without affording the lessee any access to the default clause (i.e. notice of breach and the opportunity to cure the default). Thus, an "unless" lease will terminate automatically during its primary term where the lessee fails to either drill or pay; and pretty much any lease during its secondary term will terminate automatically for failure to produce (or some proxy for production such as operations). Since no duty is engaged there is no default and therefore no right to notice. The most recent case supporting this line of reasoning is *Freyberg v Fletcher Challenge Oil and Gas Inc*, 2005 ABCA 46. The difficulty with that line of reasoning in this case is two fold: (1) this was not a lease case, and (2) the express language of Article 13. This line of cases may be of assistance to a farmor that seeks to rely on the default described in clause 13.01(A), failure to spud an earning well, but it is hard to see how this line of cases is of any utility in those circumstances in which the agreement itself does not contemplate automatic termination.

The second case on which counsel relied for the proposition that EOG had lost its right to earn was *Royal Bank v Joffre Resources Ltd* (1985), 38 Alta LR (2d) 216 (QB). The issue in that case was whether Joffre had fulfilled all of its earning obligations under a participation and farmout agreement. In that case the farmor (Pacific) was participating along with the farmee in drilling the wells and consequently was required to provide funds for the drilling operations in accordance with an attached CAPL operating procedure. The operating procedure required Joffre to make adjustments at the close of each month as between actual and estimated costs. Joffre had failed to do that leaving a significant indebtedness to Pacific. Since Joffre was now insolvent the question for the court was whether Pacific had a security interest in the interest that Joffre was earning – or in other words, was Pacific entitled to refuse to execute transfers of the interests that Joffre for properties on which Joffre had drilled wells until Joffre had settled the accounts between the parties. The issue turned on the interpretation of a clause in the farmout agreement which provided that the farmee could only earn provided that it was not otherwise in default under the agreement. Justice Medhurst found that the "agreement" included not just the terms of the farmout agreement but also the attached operating agreement. Since Joffre was in breach of the terms of the operating agreement as noted above it had not completed earning and thus Pacific was entitled to hold Joffre's interest as security for Joffre's indebtedness. One of the issues that Justice Medhurst had to address was the question of whether the "no default" provision was a condition precedent to earning that covered all possible defaults even trivial default. As to which Justice Medhurst responded that the default was hardly trivial given the significant sums involved (over $100,000 in 1980s dollars).

But in all of this of course there is no suggestion that Joffre's default had cost it the right to earn; the case is merely authority for the proposition that a farmee must fulfill all the conditions precedent to earning and that some of those conditions precedent may be imported from attached agreement such as the CAPL operating procedure. In sum, *Joffre* case provides no support for UGR's argument and Master Hanebury was surely correct to observe (at para 35) that *Joffre* is inferentially also authority for the proposition that "a default could be remedied": quite the opposite of the result for which UGR was contending.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

April 12, 2013

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!

Written by: Nigel Bankes

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):

> 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.
>
> [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.
>
> [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.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

May 7, 2013

Summary Judgment to Recover Monies Owing Under a Unit Operating Agreement

Written by: Nigel Bankes

Case Commented On: *Canada Capital Energy Corporation v Barracuda Energy Ltd*, 2013 SKQB 134

This is a nice, straightforward case in which the court granted summary judgment for amounts owing under a unitization agreement.

Facts

CCEC was the operator under a unit agreement and operating agreement in which Barracuda had a 3.71% working interest. The operating agreement provided that expenditures of over $10,000 required approval by way of an authorization for expenditure (AFE) approved by three or more working interest owners having a combined voting interest of at least 80%. Owners must respond within 15 days and failure to respond is deemed to be a vote in favour of the expenditure. Between February and March 2012 CCEC sent out 20 AFEs seeking approval for capital expenditures of $5.6 million of which Barracuda's share was $208, 422. Barracuda failed to respond but the requisite number and percentage of working interest owners did and the operator proceeded. Barracuda failed to settle the resulting invoices and CCEC commenced this action. Barracuda admitted it was a party to the agreement but defended on the basis that it had not received adequate financial disclosure of the basis of the charges or any production payments. CCEC sought summary judgment.

Judgment

Justice Whitmore granted the application for summary judgment. The affidavit evidence showed that Barracuda had received or obtained credit for all of the production payment to which it was entitled. It was no defence to say that the unit was once profitable and should still be profitable.

Commentary

There is nothing profound about this short decision but it does illustrate one important difference between a unit operating agreement and the ordinary CAPL operating agreements used for exploration and development activities in western Canada. Whereas under the CAPL agreements a joint operator cannot be made to contribute to an expenditure over a certain threshold amount

without executing an AFE, (and failure to respond is deemed to be non-consent) the prevailing norm with respect to unit agreements is, as here, majority decision making. This increases the risk for small operators who may be exposed to significant expenditures with no effective way of avoiding the liability which comes their way.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

ABlawg.ca

March 25, 2014

Decision of the High Court of Australia of Interest to Canada's Energy Bar

Written by: Nigel Bankes

Case Commented On: *Electricity Generation Corporation v Woodside Energy Ltd*, [2014] HCA 7

In this majority decision the High Court of Australia (HCA) concluded that the obligations of a seller under a gas purchase agreement (GSA) to use "reasonable endeavours" to provide the purchaser with a supplemental maximum daily quantity of gas (SMDQ) in addition to an agreed maximum daily quantity of gas (MDQ) did not require the seller to provide any gas at the SMDQ price when market opportunities emerged which afforded the seller the opportunity to sell all its available production beyond MDQ at a much higher price. While any case such as this turns on the particular language of the GSA in question, including the surrounding circumstances known to the parties and the commercial purpose or objects to be secured by the agreement, the case serves as a reminder that terms such as "best efforts" or "reasonable endeavours", at least when viewed in the self-seeking paradigm of contract, may not offer much comfort to the counterparty in this sort of commercial arrangement.

Rather than providing a detailed description of the facts of this case this post seeks to highlight the key contractual provisions in the agreement that convinced the majority to rule in favour of the seller. The most significant provisions in the GSA were the SMDQ clauses which provided as follows (at para 17):

> **3.3 Supplemental Maximum Daily Quantity**
>
> (a) If in accordance with Clause 9 ('Nominations') the Buyer's nomination for a Day exceeds the MDQ, the Sellers *must use reasonable endeavours* to make available for delivery up to an additional 30TJ/Day of Gas in excess of MDQ …
>
> (b) In determining whether they *are able to supply SMDQ on a Day, the Sellers may take into account all relevant commercial, economic and operational matters* and, without limiting those matters, it is acknowledged and agreed by the Buyer that nothing in paragraph (a) requires the Sellers to make available for delivery any quantity by which a nomination for a Day exceeds MDQ where any of the following circumstances exist in relation to that quantity:
>
>> (i) the Sellers form the reasonable view that there is insufficient capacity available throughout the Sellers' Facilities (having regard to all existing and likely commitments of each Seller and each Seller's obligations regarding maintenance, replacement, safety and integrity of the Sellers' Facilities) to make that quantity available for delivery;

(ii) the Sellers form the reasonable view that there has been insufficient notice of the requirement for that quantity to undertake all necessary procedures to ensure that capacity is available throughout the Sellers' Facilities to make that quantity available for delivery; or

(iii) where the Sellers have any obligation to make available for delivery quantities of Natural Gas to other customers, which obligations may conflict with the scheduling of delivery of that quantity to the Buyer.

(c) The Sellers have no obligation to supply and deliver Gas on a Day in excess of their obligations set out in Clauses 3.2 and 3.3 in respect of MDQ and SMDQ respectively.

(emphasis supplied by the Court).

What was convincing for the majority was the italicized language which emphasised that a seller's "ability" to supply must be assessed not only in terms of its physical ability to deliver, but also in terms of "relevant commercial, economic and operational matters". Seen within the self-seeking frame of reference of contract rather than the fiduciary's duty of undivided loyalty (the GSA expressly denounced any intention to impose a fiduciary obligation on any party, see note 56 in the decision), the Court did not hesitate long before concluding (at para 47) that the seller was entitled to take into account its own commercial interests in deciding whether it had SMDQ gas to deliver at SMDQ prices (which were considerably lower than the spot price):

> What is a "reasonable" standard of endeavours obliged by cl 3.3(a) is conditioned both by the Sellers' responsibilities to Verve in respect of SMDQ and by the Sellers' express entitlement to take into account "relevant commercial, economic and operational matters" when determining whether they are "able" to supply SMDQ. Compendiously, the expression "commercial, economic and operational matters" refers to matters affecting the Sellers' business interests. The relevant ability to supply is thus qualified, in part, by reference to the constraints imposed by commercial and economic considerations. The non-exhaustive examples of circumstances in which the Sellers will not breach the obligation to use reasonable endeavours to supply SMDQ, found in cl 3.3(b)(i), (ii) and (iii), are not confined to "capacity" (or capacity constraints). The effect of cl 3.3(b) is that the Sellers are not obliged to forgo or sacrifice their business interests when using reasonable endeavours to make SMDQ available for delivery. Verve's submission that "able" should be construed narrowly, so as to refer only to the Sellers' capacity to supply, fails to give full effect to the entire text of cl 3.3(b) and must be rejected. The word "able" in cl 3.3(b) relates to the Sellers' ability, having regard to their capacity and their business interests, to supply SMDQ. This is the interpretation which should be given to cl 3.3.

Two other extracts from the judgement are also worth quoting *in extenso*. The first passage (at para 35) is worth quoting because it encapsulates the HCA's approach to interpreting commercial contracts and in particularly succinct manner (and it will be recalled that an earlier HCA judgement, *Hospital Products Ltd v. United States Surgical Corporation*, 1984 HCA 64 had previously emerged as a significant authority in the common law world on the interpretation of contracts). This passage (references omitted) reads as follows:

> Both Verve and the Sellers recognised that this Court has reaffirmed the objective approach to be adopted in determining the rights and liabilities of parties to a contract.

> The meaning of the terms of a commercial contract is to be determined by what a reasonable businessperson would have understood those terms to mean. That approach is not unfamiliar. As reaffirmed, it will require consideration of the language used by the parties, the surrounding circumstances known to them and the commercial purpose or objects to be secured by the contract. Appreciation of the commercial purpose or objects is facilitated by an understanding "of the genesis of the transaction, the background, the context [and] the market in which the parties are operating". As Arden LJ observed in *Re Golden Key Ltd*, unless a contrary intention is indicated, a court is entitled to approach the task of giving a commercial contract a businesslike interpretation on the assumption "that the parties … intended to produce a commercial result". A commercial contract is to be construed so as to avoid it "making commercial nonsense or working commercial inconvenience".

The second passage (at paras 40 – 43, references omitted) is useful because it provides us with the Court's general views on contractual clauses like "best efforts and "reasonable endeavours":

> 40. Contractual obligations framed in terms of "reasonable endeavours" or "best endeavours (or efforts)" are familiar. Argument proceeded on the basis that substantially similar obligations are imposed by either expression. Such obligations are not uncommon in distribution agreements, intellectual property licences, mining and resources agreements and planning and construction contracts. Such clauses are ordinarily inserted into commercial contracts between parties at arm's length who have their own independent business interests.
>
> 41. Three general observations can be made about obligations to use reasonable endeavours to achieve a contractual object. First, an obligation expressed thus is not an absolute or unconditional obligation. Second, the nature and extent of an obligation imposed in such terms is necessarily conditioned by what is reasonable in the circumstances, which can include circumstances that may affect an obligee's business. This was explained by Mason J in *Hospital Products Ltd v United States Surgical Corporation* which concerned a sole distributor's obligation to use "best efforts" to promote the sale of a manufacturer's products. His Honour said:
>
> > "The qualification [of reasonableness] itself is aimed at situations in which there would be a conflict between the obligation to use best efforts and the independent business interests of the distributor and has the object of resolving those conflicts by the standard of reasonableness … It therefore involves a recognition that the interests of [the manufacturer] could not be paramount in every case and that in some cases the interests of the distributor would prevail."
>
> 42. As Sellers J observed of a corporate obligee in *Terrell v Mabie Todd & Co Ltd*, an obligation to use reasonable endeavours would not oblige the achievement of a contractual object "to the certain ruin of the Company or to the utter disregard of the interests of the shareholders". An obligee's freedom to act in its own business interests, in matters to which the agreement relates, is not necessarily foreclosed, or to be sacrificed, by an obligation to use reasonable endeavours to achieve a contractual object.

> 43. Third, some contracts containing an obligation to use or make reasonable endeavours to achieve a contractual object contain their own internal standard of what is reasonable, by some express reference relevant to the business interests of an oblige.

My final comment is that it is useful for the Canadian energy bar to see a senior appellate judgement on such an important matter as this precisely because I doubt very much that we can expect to get this sort of guidance from a Canadian court if only because of the penchant of the energy industry in Canada to opt for confidential arbitration rather than open court litigation in such matters. This is a source of disappointment for academics but it also deprives the courts of the ability to develop a transparent jurisprudence to guide the drafting of important commercial agreements. Each such arbitral award is but a single instance with no normative authority beyond the specific dispute and the particular parties to the dispute.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

June 2, 2014

Swift Judgment in a Complex Commercial Case

Written by: Nigel Bankes

Case Commented On: *Blaze Energy Ltd v Imperial Oil Resources*, 2014 ABQB 326

The Commercial Court of the English High Court is well known for its capacity to give swift judgments in complex commercial cases. This decision confirms that the Alberta Court of Queen's Bench can offer the same service provided that the parties can agree on the procedures to be followed.

The statement of claim in this matter was filed on April 23, 2014 and on April 29 Chief Justice Wittman granted a Consent Order for an expedited trial confined to three issues. Absent an Agreed Statement of Facts the trial proceeded on the basis of filed affidavits and the transcripts of cross examination on those affidavits. The Consent Order provided that there would be no questioning or *viva voce* evidence. The trial concluded on May 26 and Justice Frederica Schutz acceded to counsels' request and gave well written reasons for judgement on May 30.

The case involved two transactions (A and B) involving the purchase and sale of oil and gas assets and an interest in a natural gas processing plant (Plant) and rights of first refusal rights (ROFR) arising under two distinct agreements (the 1960 Lands Agreement and the Plant Agreement).

In Transaction A, Imperial agreed to sell its interests in certain lands to Whitecap. The sale included lands subject to the 1960 Lands Agreement which were part of a block of lands known as the West Pembina Area lands. The sale also included Imperial's 90% interest in the West Pembina Gas Plant. This Plant which was built in 1988 processes gas from the West Pembina Area including gas from lands subject to the 1960 Lands Agreement. The ownership and operation of the Plant was governed by a Construction Ownership and Operation Agreement (the 1988 CO & O Agreement or Plant Agreement). Imperial concluded that Transaction A triggered the ROFR provision in the 1960 Lands Agreement and accordingly gave notice to Blaze of the proposed sale. Imperial attributed a value of $17 million to its interest in the 1960 Lands Agreement properties in a total transaction of $855 million. In response, Blaze made inquiries as to the additional interest (Blaze already had an 8% interest) that it might be able to acquire in the Plant if it exercised its ROFR rights under the Lands Agreement. Imperial ultimately took the view that Blaze had failed to exercise its ROFR rights under the Lands Agreement in the manner prescribed by the relevant clause.

Imperial concluded that the sale of its interest in the Plant did not trigger the ROFR in the 1988 CO & O Agreement on the grounds that the disposition fell within an exception to ROFR obligations. The exception provided that "Any Owner may, without restriction, dispose of an interest in the Plant in conjunction with the disposal of the Owner's corresponding working interest in the lands in the West Pembina Area from which Gas is being produced into the Plant." Imperial advised the relevant parties, including Blaze, that it was taking this position.

In Transaction B, Whitecap agreed to sell Keyera a portion of the assets that it had acquired from Imperial, specifically an 85% interest in the Plant and a corresponding interest in Gas assets in the West Pembina Area. Whitecap provided Blaze with a ROFR notice under the Lands Agreement but, relying again on the exception referred to above, did not provide a ROFR notice under the CO & O Agreement. Blaze exercised its ROFR rights under the 1960 Lands Agreement and then took the position, crucial to this litigation (at para 64) that if it acquired Whitecap's interest in these lands Whitecap could no longer be said to be selling a "corresponding working interest" in the West Pembina Area Gas Lands to Keyera. Thus, Blaze argued, Whitecap could not take advantage of the exception in the CO & O Agreement and must therefore offer Blaze the opportunity to acquire at least some level of additional interest in the Plant.

The Consent Order directed an expedited trial of three issues:

> (a) Does Blaze have the ROFR rights it claims to have in relation to Transaction A?
>
> (b) Does Blaze have the ROFR rights it claims to have in relation to Transaction B?
>
> (c) If Blaze has ROFR rights is it entitled to specific performance?

Justice Schutz concluded that Blaze failed on all three grounds.

(a) Does Blaze have the ROFR rights it claims to have in relation to Transaction A?

Blaze claimed a right to acquire a 4% interest in the Plant as a result of Transaction A. Blaze fixed on 4% on the basis that the 1960 Lands provided about 4% of Imperial's production to the Plant from the West Pembina Area over the previous five years.

The short answer to this claim is that neither the 1960 Lands Agreement nor the CO & O Agreement gave Blaze any such right. Furthermore, the Agreements could not be read together to produce such a result since there was no evidence that the two agreements were intended to be connected. One only has to refer to the dates of the two agreements (1960 and 1988) and the different lands served by these two agreements to see that this must be the case.

> [17] Put plainly, the 1960 Lands Agreement has nothing whatsoever to do with rights or interests in the Plant and nothing subsequent to the 1960 Agreement has changed that fact.

Blaze also claimed that Imperial's notice under the 1960 Lands Agreement was defective on the basis that it failed to connect the Lands transaction with the Plant transaction and the later Disposition B (see para 108). For the reasons already stated this submission was doomed to failure insofar as it depended on being able to read the Agreements together, but it also meant that Blaze had failed to exercise its ROFR rights under the Lands Agreement. That was fatal: see para 123 and subsequent discussion of *Pierce v Empey*, [1939] SCR 247 and *Chase Manhattan Bank of Canada v Sunoma Energy Corp*, 2002 ABCA 286, at paras 161 et seq.

(b) Does Blaze have the ROFR rights it claims to have in relation to Transaction B?

There appears to be no issue with respect to Blaze's rights as against Whitecap under the 1960 Lands Agreement. However, Justice Schutz had no hesitation in concluding that the exercise of Blaze's rights under the Land Agreement could have no effect on the ability of Whitecap to claim the benefit of the exemption under the CO & O Agreement. This must be right. The two agreements are independent (at para 148) and in any event, as Justice Schutz points out (at para 144), the CO & O Agreement uses the term "corresponding" and not "identical".

(c) If Blaze has ROFR rights is it entitled to specific performance?

Justice Schutz gave three reasons for concluding that specific performance would not be available. First, and with respect to the alleged Plant ROFR entitlement arising under Transaction B, the alleged interest was far too contingent to permit an order of specific performance (at para 158): "Blaze cannot persuade me … that there is unambiguous content or object or subject-matter to the claimed Plant ROFR … Blaze resorts to altering the express contractual language … and contorts the plain meanings" of the relevant clauses in the two agreements. Second, and with respect to the Lands ROFR under Transaction A, Blaze had failed to comply with the terms of the ROFR (see references above to *Pierce* and *Chase Manhattan*). And finally Justice Schutz was prepared to apply the clean hands doctrine to forestall claims to relief on the grounds that there was evidence that Blaze was in default under the CO & O Agreement. While this latter hardly seems to be closely enough connected to be a relevant consideration, the first two grounds are convincing. Interestingly, Justice Schutz did not find it necessary to refer to *Semelhalgo v Paramadevan*, [1996] 2 SCR 415 although it was certainly provided to her.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

CC BY NC ND

ABlawg.ca

Swift Judgment in a Complex Commercial Case

Comments:

Nigel Bankes says:

August 30, 2014 at 8:19am

> Justice Schutz's decision on costs is available at 2014 ABQB 509. Justice Schutz rejected the defendants' claims to a costs award based on a percentage of solicitor client fees rather than on the basis of the tariff. She did however order enhanced costs (a multiplier of 1.5); Imperial was entitled to double that on the basis of formal, bona fide offer to settle on terms of "$1.00 inclusive of all claims, including costs".

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

CC BY NC ND

August 18, 2014

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?

Written by: Nigel Bankes

Case Commented On: *IFP Technologies (Canada) v Encana Midstream and Marketing*, 2014 ABQB 470

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:

> [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:

> [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:

> [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:

> [405] 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.
>
> [406] …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.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

November 7, 2014

Gross Negligence and Set-off Rights under the 2007 CAPL Operating Procedure

Written by: Nigel Bankes

Case Commented On: *Bernum Petroleum Ltd v Birch Lake Energy Inc*, 2014 ABQB 652; unreported transcript of reasons of Master Robertson, July 31, 2013

Bernum and Birch Lake held interests (60:40) in five sections of land (sections 3, 7, 8, 17 and 19) governed by the 2007 version of the CAPL operating procedure. Bernum was the operator. Birch Lake elected to participate in drilling two horizontal wells, the 4-3 well and the 6-19 well. The 4-3 well was a success and is still producing. The 6-19 failed and was subsequently abandoned. Birch Lake failed to meet cash calls under the authorizations for expenditure (AFEs) for the two wells; Bernum commenced an action and applied for summary judgement. Bernum also set off Birch Lake's share of production against Birch Lake's indebtedness.

Birch Lake defended Bernum's application for summary judgement on the basis that Bernum had been grossly negligent in drilling the two wells. The 2007 CAPL provides that:

> 4.02 The Operator … will not be liable to any of the Non-Operators for any Losses and Liabilities resulting from or in any way attributable to or arising out of any act, omission or failure to act, whether negligent or otherwise, of the Operator or its Affiliates and their respective directors, officers, agents, contractors or employees in the performance of the Operator's duties under this Agreement (including those in planning or conducting any Joint Operation), except insofar as:
>
> (a) those Losses and Liabilities are a direct result of, or are directly attributable to the Gross Negligence or Wilful Misconduct of the Operator …;

Unlike earlier versions of the CAPL operating procedure, the 2007 version provides a definition of Gross Negligence or Wilful Misconduct:

> … any act, omission or failure to act (whether sole, joint or concurrent) by a person that was intended to cause, or was in reckless disregard of, or wanton indifference to, the harmful consequences to the safety or property of another person or to the environment which the person acting or failing to act knew (or should have known) would result from such act, omission or failure to act. However, Gross Negligence or Wilful Misconduct does not include any act, omission or failure to act insofar as it: (i) constituted mere ordinary negligence; or (ii) *was done or omitted in accordance with the express instructions or approval of all Parties, insofar as the act, omission or failure to act otherwise constituting Gross Negligence or Wilful Misconduct was inherent in those instructions or that approval* (emphasis added).

Birch Lake also counterclaimed with respect to sections 7, 8 and 17. The leases on these lands had been allowed to expire in accordance with their terms but Bernum then re-leased them in its own name and for its own account. Birch Lake argued that Bernum had failed in its obligations under the CAPL to maintain the co-owners' interest in the original leases and that the subsequent acquisition of new leases on these properties was subject to an area of mutual interest (AMI) obligation, or, that in acquiring these leases in its own name and for its own account, Bernum was in breach of a fiduciary obligation owed to Birch Lake. Bernum took the position that the AMI obligations had expired.

Master Robertson granted Bernum summary judgement on the amounts owing under the cash calls but stayed execution of that judgement for one year to allow the parties to proceed to trial on the AMI issue – apparently so as to allow Birch Lake to establish set-off. Master Robertson denied summary judgement on the AMI issue and the other issues relating to the section 7, 8 and 17 lands since while the AMI obligation on its face had expired, there was an argument that it had been extended by the conduct of the parties; and the agreement did not prescribe that any amendments had to be in writing.

Birch Lake appealed and Bernum cross appealed the stay. Both parties adduced additional evidence on the appeal.

Justice Pentelechuk agreed that Bernum was entitled to summary judgement on the cash calls with no further stay (at para 118). There was no evidentiary basis for the claims of gross negligence and in any event Birch Lake must be taken to have approved the mudding program proposed by Bernum in its AFE (see the italicized text in the definition of gross negligence, *supra*). The following paragraphs summarize her conclusions on these matters:

> [46] The determination of each case of gross negligence or wilful misconduct is not only fact- but context-specific. The oil and gas industry is a high risk, speculative business, particularly for junior participants who often operate on precarious financial foundations. As admitted by the parties, many things can go wrong during the course of drilling, resulting in unanticipated delays and cost overruns. Often, decisions in the course of drilling must be made quickly without time for extended consultation or analysis. A well may not produce as expected or may not produce at all.
>
> [50] There is nothing in the record to suggest the 4-3 well would have produced at a higher rate had a different mud system been employed or that the difficulties with the 16-19 well would have been avoided if different drilling operations were employed. In other words, while there is criticism aimed primarily at the mud system utilized, it begs the question whether utilization of a different mud system would have led to a different result. With the benefit of hindsight and time, it may be established that utilization of a different mud system would have been preferable in the circumstances, but Birch Lake must put its "best foot" forward now.
>
> [51] Taking Birch Lake's evidence at its highest and ignoring the evidence put forward by Bernum, Birch Lake has failed to establish that its defence of gross negligence in relation to the operation of the wells is an issue of merit requiring a trial. The record does not disclose evidence showing a conscious wrongdoing or a very marked departure from

> the standard expected of an operator like Bernum. Part of the problem is Birch Lake's failure to lead evidence on industry standards by which the actions of Bernum could be compared. For example, Birch Lake points to Bernum's choice of mud programs, and its decision to use the same program on the 16-19 well, but provides no evidence to suggest the mud system utilized was contrary to industry standards. In contrast, Bernum led evidence that the mud program utilized is the standard program used by operators in the area.

Justice Pentelechuk also agreed that it would be inappropriate to grant summary judgement with respect to any of the matters in relation to the section 7, 8 and 17 leases. The provision in the 2007 CAPL to the effect that all amendments to the agreement must be in writing did not apply to the head agreement since in the event of a conflict between CAPL 2007 and the head agreement the head agreement must prevail. The head agreement as noted above did not require that amendments to the AMI agreement must be in writing. It is possible however that the *Statute of Frauds* may be relevant to the question of writing (at para 74).

Justice Pentelechuk appears to have given two types of reasons for denying any extension of the stay ordered by Master Robertson. As noted above, Master Roberston seems to have granted the stay so as to allow Birch Lake to establish a right of equitable set-off. Justice Pentelechuk however drew the attention of the parties to cl.5.05B(d) of the 2007 CAPL which provides that the operator may

> … maintain actions against that Non-Operator for all such unpaid amounts and interest thereon on a continuing basis, as if those payment obligations were liquidated demands payable on the date they were due to be paid, *without any right of that Non-Operator to set-off or counter-claim* (emphasis added).

In her view this clause is one of a number of clauses which (at para 94) "provide an operator with expedited and enhanced remedies not available to an ordinary creditor."

> [95] These enhanced remedies reflect the high risk and high reward world of oil and gas exploration. These provisions discourage non-operators from delaying payment of their agreed upon share of operating costs because production is lower than expected.

As such, potential set-off claims (at para 104) "cannot be raised as a means to refuse or delay payment of operating costs due and owing."

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**

April 13, 2015

Summary Judgment on Contested Amounts Owing under Natural Gas Processing and Related Agreements

Written by: Nigel Bankes

Case Commented On: *SemCAMS ULC v Blaze Energy Ltd*, 2015 ABQB 218

This is an important judgment on the interplay between the rules for the interpretation of contracts and the post *Hryniak* law on summary judgment: see *Hryniak v Mauldin*, 2014 SCC 7. The short version of the holding is that a producer cannot avoid summary judgment for outstanding amounts owing under a natural gas processing or related agreement on the basis that the producer has called for an audit of the operator's accounts or otherwise disputes the amounts owing – at least where the agreements in question clearly oblige producers to settle invoices promptly, notwithstanding the existence of a dispute as to whether the invoices properly reflect the amounts owing.

Blaze was the successor in interest to a number of agreements pursuant to which SemCAMS provided gas transportation, gas processing and contract operating services. These agreements all provided, as one might expect, that producers such as Blaze would promptly settle their accounts once properly invoiced. Given the challenges involved in both assessing actual costs and allocating those costs to particular gas streams, the agreements in question provided both a means for truing up accounts (13th month adjustment) and a means for allowing producers to question the accounts by way of audit.

The action related to invoices served by SemCAMS between July 2012 and April 2013 for a total of $6.9 million; remarkably (at para 11) "Blaze has made no payments whatsoever to SemCAMS, despite the fact that SemCAMS has been processing its gas since June 2012." Blaze had filed a counterclaim, alleging, *inter alia*, wrongful shutting in of its wells.

Some, but importantly not all, of the agreements expressly stated (at para 13) that the "Producer shall not be allowed to withhold payment of any portion of the bill presented by the Operator, due to a protest or question relating to such bill"; and others provided that the Operator can maintain an action for unpaid amounts "as if the obligation to pay such amount and the interest thereon were liquidated demands due and payable on the relevant date such amounts were due to be paid, without any right or resort of such Producer to set-off or counterclaim".

The evidence before the Court on this application for summary judgment consisted of affidavits by an official of each company and the transcripts from the questioning on those affidavits. Justice Jo'Anne Strekaf summarized (at para 24) the tests for summary judgment drawing on the Court of Appeal's decision in *Windsor v Canadian Pacific Railway Ltd*, 2014 ABCA 108 as follows:

> Summary judgment is now an appropriate procedure where there is no genuine issue requiring a trial:

> There will be no genuine issue requiring a trial when the judge is able to reach a fair and just determination on the merits on a motion for summary judgment. This will be the case when the process (1) allows the judge to make the necessary findings of fact, (2) allows the judge to apply the law to the facts, and (3) is a proportionate, more expeditious and less expensive means to achieve a just result.
>
> The modern test for summary judgment is therefore to examine the record to see if a disposition that is fair and just to both parties can be made on the existing record.

On this record, SemCAMS sought judgment for the full invoiced amount (subject to one adjustment) on the basis that the contracts contemplated immediate recovery notwithstanding the potential for subsequent adjustments (at para 38). Blaze on the other hand argued that SemCAMS' interpretation of the contracts led to an absurdity since it "suggests that Blaze would be obligated to pay whatever SemCAMS invoiced and that underpinning the obligation to make a payment under the Agreements is the requirement that the invoices reasonably reflect the goods or services that were provided" (at para 40).

Justice Strekaf rejected Blaze's absurdity argument. She concluded (at para 48) that:

> It can be inferred that the Operator needs to be able to rely on a reliable cash flow. If there was a dispute between the Operator and a Producer as to the amounts owing, the parties could have decided to allocate the risk so that either the disputed amount could be withheld by the Producer pending resolution of that dispute, or that it would be paid and subsequently adjusted following resolution of that dispute. The language used in this case suggests that they chose the latter approach. This arrangement is not an unreasonable allocation of risk.

In doing so Justice Strekaf immediately acknowledged (at para 49) that this was perhaps an unusual situation:

> Typically in order for a party who provides services under an agreement to collect on an unpaid account that they must satisfy the Court that the amounts are ultimately owing under the agreement, not that they have simply been billed. It is unusual that a party would be able to obtain summary judgment on the basis of amounts billed, subject to subsequent adjustment following an audit. However, in this case the language used by the parties in the Agreements in the context of an Operator providing gas processing and transportation services to numerous parties supports that interpretation as reflecting the true intention of the parties.

Justice Strekaf's judgment clearly turns on the language of the particular contracts; but, given that similar language will be used in the many different types of agreements adopted by the oil and gas industry in western Canada, the implications of this judgment are potentially very far reaching. To the extent that the judgment will make it difficult for a producer to postpone or

dodge its obligations to pay, even any amount owing, simply by triggering the audit provisions of the relevant agreements, I suspect that the judgment will be broadly welcomed; and if upheld on appeal it certainly provides useful guidance as to the type of contractual language that operators need to insist upon as part of obtaining effective remedies to secure necessary cash flow in return for services provided.

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**