December 3, 2015

Court of Appeal Assesses Damages for Production on a Dead Oil and Gas Lease: An Important but Ultimately Disappointing Decision

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Case Commented On: *Stewart Estate v TAQA North Ltd*, 2015 ABCA 357

Courts of Appeal have at least two important functions. The first is a corrective function – the power and the authority to take a second look at a problem and to reach a decision which more properly accords with the law. For a recent example which demonstrates the crucial importance of this role see the Court of Appeal's review of Judge Camp's infamous decision in *R v Wagar*, 2015 ABCA 327, which was the subject of important commentary by my colleagues, Professors Koshan and Woolley here and here. In many cases, the scope of that corrective function turns on the applicable standard of review: correctness, unreasonableness or overriding and palpable error. One of the important issues in *Stewart Estate v TAQA North Ltd* was the application of the Supreme Court of Canada's decision in *Creston Moly Corp v Sattva Capital Corp,* 2014 SCC 53 (CanLII), [2014] 2 SCR 633 (*Sattva*) to the interpretation of oil and gas leases. *Sattva* is generally cited as authority for the proposition that unless there is an "extricable question of law", a trial judge's interpretation of a contract should generally be accorded deference. Thus, an appellate court should only intervene if it is of the view that the trial judge has made an overriding and palpable error – the traditional test for an appellate court's assessment of a trial judge's findings of fact. The principal rationale for applying the same test to contract interpretation issues as well as to findings of fact is that the rules on contractual interpretation allow a trial judge to take into account the factual and commercial matrix when assessing the intentions of the parties as revealed in the language used in the contract.

A Court of Appeal's second function is to clarify the law and resolve competing interpretations of the law by lower level courts. For a comment on this role of the Court which also happens to involve the issues of lease validity and assessment of damages see my comment on the Court of Appeal's decision in *Canpar Holdings Ltd. v Petrobank Energy and Resources Ltd.*, 2011 ABCA 62 here. It is obvious that a multi-person appellate court is best able to deliver on this clarification function where it speaks with a single voice and a clearly discernible *ratio decidendi* and through a "reserved" judgment i.e. a judgment that has been circulated beyond the panel deciding the case to the full court. When combined with the doctrine of *stare decisis* such a judgment should perform an important clarifying role for lower courts. An appellate court offers less guidance when there are multiple judgments, even where those judgments concur in the ultimate result. This is such a case and it is why, as the title to this post suggests, that while *Stewart Estate* is certainly a significant decision (which grapples with important issues including, the standard of review applicable to lease interpretation questions, the rules surrounding the termination of oil and gas leases and the question of remedies for wrongful production), it is ultimately a disappointing decision because, in the end, with three separate judgments, this three person panel of the Court agrees on very little.

All three members of the Court agree that most of the leases in question expired in accordance with their terms, and all three agree that in this particular case, damages for unlawful production on a dead lease should not be assessed on the basis of the so-called royalty approach. In terms of result therefore, the Court unanimously reverses Justice Romaine's judgment at trial which I commented on here. But the individual members of the Court disagree on just about everything else including the reasons why the leases had expired and the approach for assessing damages in this case. As a result, this decision has done little to clarify the law on lease expiration and remedies and is therefore sure to invite further litigation exploiting the points of disagreement. This may be in the interests of the oil and gas litigation bar, but it is certainly not in the interests of lessors or lessees; neither does it serve to enhance the reputation of the appellate courts. For these reasons I hope that the lessees seek leave to appeal and that the Supreme Court gives that leave on the grounds that there are issues of national importance that need to be resolved. Not least of these is the clear difference in approach to remedies and the assessment of damages exhibited by the Alberta Court of Appeal in this case and the Saskatchewan Court of Appeal in *Montreal Trust Co v Williston Wildcatters Co*, 2001 SKQB 360 (CanLII), aff'd 2002 SKCA 91 (CanLII), 223 SaskR 276 and followed in Alberta at the Queen's Bench level in *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2007 ABQB 353 (CanLII), 428 AR 102 but arguably not by the Court in *Canpar Holdings Ltd v Petrobank Energy and Resources Ltd and Gentry Resources Ltd*, unreported transcript of reasons for judgment October 9, 2009 and December 11, 2000 (rev'd on appeal, see above) and the subject of an earlier ABlawg post here.

This post cannot review all of the issues that arise in this nearly 100 page judgment but it does touch on the following issues: (1) standard of review issues: the application of *Sattva,* (2) the construction of the third proviso and the expiration of the leases, (3) the date of expiration, the date production became unlawful, the doctrine of leave and licence and the role of limitations rules, (4) the legal status of production operations on a dead lease, the remedy, and the assessment of damages, and (5) the liability of the gross overriding royalty owner (Esprit).

First, however a summary (and readers should note that there is also a useful Executive Summary in the first two pages of Justice Rowbotham's judgment).

Summary

Standard of review of the trial judge's conclusions on the interpretation of the leases: Sattva. The majority (McDonald JA, O'Ferrall JA concurring)) would review for correctness; Justice Rowbotham (dissenting on this point) would review on the standard of palpable and overriding error.

The construction of the third proviso and expiration of the leases. A majority (O'Ferrall JA, McDonald JA concurring) concluded that the lessees were not in a position to rely on the ameliorative language of the proviso permitting non-production for lack of an economic market. A lessee can only rely on these exceptional provisions if the lessee has a well on the lands that is otherwise capable of production. The majority concluded that that was not the case here since the lessees had successively abandoned both of the producing formations in the only well on the leased lands. Justice Rowbotham, concurring in the result, concluded that the leases expired since market conditions had improved such as to permit economic production from the well some time before it was in fact recompleted and produced. The majority appears to support this conclusion in the alternative. The majority's findings applied to all of the leases covering the pooled lands.

Date of expiration, the date production became unlawful, the doctrine of leave and licence and the role of limitations rules. The majority (O'Ferrall JA, McDonald JA concurring) held that the leases expired (1995) when the well was abandoned in both of its producing formations. Justice Rowbotham concluded that the leases expired in January 2000 by which time the lessees could have produced the well into an economic market.

A different majority (Rowbotham JA, McDonald JA concurring) held that production was prima facie tortious as of lease expiry (for Rowbotham JA this is clearly January 2000) but that the lessors, for limitations reasons, could only recover for the two years immediately prior to filing of the statement of claim such that there could be no recovery for wrongful production prior to August 9, 2003. Justice O'Ferrall (dissenting on this point) concluded that the lessees' continuing presence on the lands did not become unlawful until after the statement of claim had been filed and the lessees served with a notice to vacate (September 2005). Thus, in his view, there could be no recovery for production prior to September 2005.

The legal status of production operations on a dead lease, the remedy, and the assessment of damages. All three members of the panel concluded that the lessees' actions fitted the elements of the causes of action in both trespass and in conversion. The majority (Justice Rowbotham, O'Ferrall JA concurring) assessed damages on the basis of proceeds of production minus operating costs: i.e. a disgorgement remedy. Justice McDonald (dissenting on this point) would also have ordered disgorgement but without any allowance to the lessees for their operating costs.

The liability of the gross overriding royalty owner (Esprit). All three members of the panel concluded that Esprit was not jointly and severally liable for the wrongful production as a whole. However, the majority (O'Ferrall JA, McDonald JA concurring) held that Esprit was liable to account for the monies it received for its royalty share of production. Justice Rowbotham (dissenting on this point) concluded that Esprit was not liable to the lessors either directly for its own behavior (which was not tortious), or on the basis of agency.

Standard of Review Issues: The Application of *Sattva*

While the Court of Appeal has already had several opportunities to comment on the implications of *Sattva*, this was the Court's first opportunity to consider the application of *Sattva* to a trial judge's interpretation of the terms of a petroleum and natural gas lease. There is a useful list of Alberta *Sattva*-application cases at para 269 (per Justice McDonald). The Court split on this important issue. Justice McDonald (with Justice O'Ferrall concurring) for the majority adopted a standard of correctness. Justice Rowbotham (dissenting on this point) concluded that there was no reason not to apply the main holding in *Sattva* and accordingly proceeded to assess Justice Romaine's lease interpretation conclusions against the palpable and overriding error standard.

Justice McDonald for the majority gives two main reasons for preferring the correctness standard. The first (at paras 271 – 279) is that if the rationale for *Sattva* is that the interpretation of a contract will frequently involve mixed questions of fact and law because of the admissibility of evidence relating to the surrounding circumstances (and the application of the terms of the contract to the facts) this rationale cannot be an important consideration with respect to a standard form oil and gas lease. Such a lease is effectively a contract of adhesion with negotiations limited to two variables: the amount of the bonus payment and the amount of the delay rental. Second, given that the oil and gas industry has developed a standard form lease (albeit with variations, at paras 276 and 283), it would be intolerable were different trial judges

to reach different (and unreviewable) conclusions with respect to the interpretation of the same lease form and language (at para 283). In reaching this conclusion Justice McDonald was clearly heavily influenced by the Court of Appeal's decision in *Vallieres v Vozniak*, 2014 ABCA 290 in which the Court held that a trial judge's interpretation of a standard form real estate purchase and sale contract should be reviewed by an appellate court on the basis of correctness.

Justice Rowbotham (dissenting on this point) reasoned (at para 62) that the admissibility of evidence as to contextual issues surrounding matters such as the expectations of the parties and concerns as to drainage militated in favour of the palpable and overriding error approach (at para 63):

> Given … *Sattva*'s reliance on cases that appear to have interpreted standard form contracts to reach the conclusion that the correctness approach to appellate review of trial decisions is no longer appropriate except in the most exceptional cases, I am persuaded that the trial judge's interpretation of these leases is reviewable on the palpable and overriding error standard unless the decision reveals an extricable error of law or principle.

My own view is that while the differences in lease forms are more significant than suggested by Justice McDonald, it is still important that courts take the same approach to the interpretation of these different lease forms. A more pluralistic approach will undoubtedly encourage more litigation, especially given the economic stakes at issue. For that reason, the correctness approach to the interpretation of these lease forms does seem preferable and can be reconciled with *Sattva* given that the findings in one case will have implications for other similarly worded leases.

The Expiration of the Leases

There were five leases at issue in this case. All were essential in the sense that all of the leases related to a portion of a single drilling spacing unit and all the leases had been pooled. All of the parties and all three members of the Court appeared to accept the proposition that the expiration of one lease would affect the validity of the pooling and hence the validity of all of the other leases. However, there was some concern that not all the proper parties with interests in two of these leases were before the Court. The majority, (Justice O'Ferrall and Justice McDonald concurring (at para 267)) did not regard the absence of some interested parties as material and concluded that all five leases had expired. There is a certain logic to this position insofar as it draws on the pooling reasoning outlined above. Essentially, the point is that if one of the pooled leases is invalid then all are invalid and it must make little if any substantive difference (there may still be a procedural fairness issue) if all of the potential parties with affected interests in other leases that contribute to the pooling are before the court (see para 448). Justice Rowbotham (paras 131 – 155, dissenting on this point) was unwilling to make definitive rulings with respect to those two leases. All three members of the Court were however prepared to conclude that three of the leases had expired in accordance with their terms (and the same reasoning does in fact extend to the remaining two leases although of course Justice Rowbotham could not (at para 155) opine on that point).

The Court discusses two distinct lease expiration arguments. The first argument, espoused by the majority (O'Ferrall JA, McDonald JA concurring), was that the leases expired in 1995 when the productive formations in the 7-25 well were abandoned. Abandonment of these productive formations meant that there was no well on the lands that was capable of production and that therefore the ameliorative provisions of the third proviso were not available to the lessees at all – they were inapplicable. The second argument, championed by Justice Rowbotham, by-passed the

first argument but still concluded that the leases had expired on the basis that the 7 – 25 well could have produced into an economic market before it did so.

No Well Capable of Production: The Majority

As noted above, the majority concluded that the leases expired in 1995 when the productive formations in the 7-25 well were abandoned. Abandonment of these productive formations meant that there was no well on the lands that was capable of production and that therefore the ameliorative provisions of the third proviso were not available to the lessees at all. This conclusion turns on a careful and detailed analysis of the facts surrounding the shut-in of the 7 – 25 well.

The 7-25 well was drilled in 1968. It encountered sour gas in the targeted Crossfield Member of the Stettler Foundation in the Wabamun group but it also encountered sweet gas in the Basal Quartz formation (BQ). The lessees elected to produce from the BQ formation until the single well BQ pool that the 7-25 well had discovered was depleted (1981). Then, the lessees, having recompleted the well two years earlier in the Crossfield, produced and processed sour gas from the Crossfield formation from 1981 to 1995. However, gas from the well could not readily be processed at the lessee-owned Balzac plant and was instead processed under contract at the non-lessee owned East Crossfield plant - and on less than favourable best-efforts terms (at para 366). The well also experienced deliverability problems (at para 369) but the lessees were reluctant to incur the costs associated with further stimulation of the well. One result of the deliverability problems was that TransCanada reduced the nomination attributable to the well under its gas purchase contract with the lessees. It was in these circumstances (declining production, deliverability issues and high costs) that the majority (per Justice O'Ferrall (Justice McDonald concurring)) concluded that the lessees decided not just to suspend temporarily production, but effectively to abandon the well in the Crossfield Formation (having previously abandoned the BQ formation):

> [372] It is important to distinguish between interrupting or suspending production from a well capable of production and ceasing production from a formation which is no longer commercially productive. It is important to make this distinction because the fourth proviso in the lease provides some relief only for production operations which are "interrupted or suspended". In 1995, production from the Crossfield Member was not being interrupted or suspended. Production was being brought to an end and the producing formation abandoned. Subsequent events and the fact that the lessees never resumed production from the Crossfield Member bear this out.
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> [373] A lack of or an intermittent market was <u>not</u> the cause of the cessation of production from the 7-25 Well. Continued production was simply uneconomic and there was no foreseeable prospect of that situation changing. From that point forward, the lessors were simply holding on to a lease which had terminated in accordance with its terms (the emphasis is Justice O'Ferrall's).

Further evidence that the actions of the lessees were tantamount to abandonment came from the physical and contractual steps that the lessees took in relation to the well (at para 382):

> What happened next was that the 7-25 Well was shut in a tubing plug and inhibitor set, and the wellhead locked. Surface equipment necessary to produce

> the well from any formation was removed. The well owners cancelled their gas processing agreement with the owners of the East Crossfield gas plant, thereby giving up their share of the East Crossfield gas plant's processing capacity. Their contract operating agreement with Amoco (also operator of the East Crossfield Gas Unit and the East Crossfield plant) was cancelled. They also released their firm transportation capacity with Nova or TransCanada. The well's maximum daily contract (purchase) nominations were cut by TransCanada to zero. And, significantly, in light of what happened later, even the sweet gas gathering line which had been used to take away production from the BQ formation was abandoned. Further production from the BQ formation was not contemplated in 1995.

The legal implication of all of this is that the majority (per Justice O'Ferrall, Justice McDonald concurring) held that the lessees never triggered the interruption or suspension language of the proviso because (at para 389) "There was, in fact, a complete cessation of production" and furthermore, with the physical actions taken above, there was no longer a well capable of production on the lands and that was a condition precedent to relying on the interruption and suspension provisions (at paras 389, 395 & 407 – the proviso is simply inapplicable). In this case, before the well could be turned on again (as ultimately it was in 2001, but from the BQ formation) the following steps had to be taken (at para 392):

> ... the 7-25 Well did have to be recompleted in an entirely different zone at a cost of about a half million dollars. A drilling rig had to be brought onto the lease to recomplete the well in the BQ formation. A pipeline to take away the production from the well had to be constructed (or the previously-abandoned production pipeline unplugged and recommissioned). Firm transportation on TransCanada had to be obtained and either a new gas purchase contract entered into or an existing one amended with respect to contract quantities.

In sum, the leases terminated when (1995) the well was abandoned in both formations from which it had produced. At that time there was no well on the lands capable of production.

Expiration for Failing to Produce When There Was a Market: Justice Rowbotham

There were two elements to this argument. The first element was an interpretive issue. The second element involved the application of the authoritative interpretation to the facts. As to the first, the lessors wanted to insist on a strict and literal interpretation of the lease language and thus, since the market at the relevant time was deregulated, the lessees should have been able to produce if they lowered their price. The lessees, however, contended that they could not be expected to produce at a loss and thus argued that the reference to market should be understood to include the lack of an economical or profitable market. At trial, Justice Romaine sided with the lessees, as did Justice Rowbotham on appeal applying (at paras 77 – 78) the deferential standard of review. Perhaps the key passage is this (at para 75):

> … it could not have been the objective intention of the parties to insist that the lessee market the produced substance when it was uneconomical or unprofitable. As the trial judge observed, a contextual reading of the phrase suggests a broader interpretation than the literal and narrow interpretation advanced by the appellants. However, to be clear, this is not an interpretation which suggests that a

> lessor would agree to tie up its land beyond the primary term for speculative purposes.

As for the application of this interpretation to the facts, Justice Rowbotham concluded that Justice Romaine had made a palpable and overriding error in concluding that the lessees had re-commenced production in a timely way. The 7-25 well was shut in from July 1995 until February 2001 but the expert evidence tended to show that by no later than January 2000 recompletion of the well was economic. By allowing the lessees to defer production until the economics of the well became more "attractive" or "compelling" Justice Romaine erred. Such an approach was unduly deferential to the interests of the lessees and failed to take into account the presumed commercial interests of the lessors. Justice Rowbotham put the point this way:

> [125] The trial judge was entitled to conclude that the market for the produced substances must be economical or profitable. However, she erred in principle when she assessed profitability solely from the perspective of the lessees without giving equal weight to what was commercially viable and sensible from the lessors' perspective. As was said in *Freyberg* and *Omers*, lessors would not agree to tie up land when it was no longer commercially viable from their perspective.
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> [126] I conclude that on the evidence of the respondents' own expert, it was profitable for a prudent operator to recomplete the 7-25 Well no later than January 1, 2000. In January 2000, by all objective measures (i.e., the three hurdle rates referred to earlier), it became economical and profitable to resume production. The fact that it was not yet "compelling" or "very" profitable (to use the words of the trial judge's preferred expert) from the perspective of these particular lessees, under-emphasizes the commercial objectives of the lessors.

Given the manner in which the majority approached the issue of lease expiration, the majority had no need to examine either the interpretation of the term market or the application of the authoritative interpretation to the facts. However, it does appear that the majority would have agreed with Justice Rowbotham on both elements of this argument were it necessary to address the two points. This seems clear from Justice O'Ferrall's brief but pointed comments (at para 394):

> The trial judge read into the lease the requirement that the market be economic or profitable. I do not believe she erred in so doing, but there could also be no doubt that a market for the gas existed and that it was profitable. Offsetting wells were selling gas into that market.

Justice O'Ferrall also makes it quite clear, however, that in assessing the profitability of the market, no account should be taken of the capital expenditures that might be required of the lessee in order to turn the tap back on. This is a useful, important and principled characterization which flows (at para 406) from the passive nature of the royalty interest:

> ... these [factors] ... had nothing to do with the fourth proviso [because] ... under the leases, the lessors were indifferent to those capital costs. Lessor royalties are not subject to any of the costs of bringing the leased substances to the surface. .... Just as the lessors are not concerned about the capital cost of drilling the well in the first instance, they also are not concerned about the costs of stimulation, abandonment or re-completion. Those are costs borne by the lessees and are not expenses incurred to render the gas marketable and are therefore not taken into account in calculating the lessors' royalties. Nor are the lessors concerned about

> the risks associated with these production operations, which risks played a prominent role in the lessees' expert's opinion that continued production of the well was not economic. The lessors' only concern is that the revenue from sales of the natural gas exceeds the costs of rendering it marketable.

The point is important with respect to this second ground for assessing lease expiration because it goes to the issue of what factors are relevant in concluding whether the market is "economical" or profitable. Justice Rowbotham seems to take on board the idea of assessing whether or not the lessees' investment hurdle rates can be met as part of establishing profitability; but if those investments include the cost of re-completion, then the majority, per Justice O'Ferrall, would presumably say that those costs, and the internal hurdle rates associated with a return on those investments, are irrelevant to assessing the profitability of ongoing production.

Date of Termination, the Date Production Became Unlawful, the Doctrine of Leave and Licence, and the Role of Limitations Rules

Given the differences between the majority per Justice O'Ferrall (McDonald JA concurring) and Justice Rowbotham as to what caused the leases to terminate, it follows that they must also have different views as to *when* the leases terminated – 1995 for the majority and 2000 for Justice Rowbotham. In the end however these difference are mediated by the application of the *Limitations Act* (which limited the lessors to recovering under conversion or trespass for the two years prior to the date of filing of the statement of claim, August 9, 2005 (at para 174)) and application of the doctrine of leave and licence.

The majority (this time per Justice Rowbotham, McDonald JA concurring) were evidently of the view that production from the leased lands was unlawful as of lease expiration (January 1, 2000 (at para 129) – at least for Justice Rowbotham, Justice McDonald is committed to lease termination as of 1995) and that the lessors would therefore be entitled to a declaration to that effect (at para 161). However, no remedial order (i.e. damages) could reach back prior to August 9, 2003 (at paras 161 & 183) – and in relation to one set of lessors, Justice Rowbotham finds a leave and licence that protects the lessees from liability until their lessors joined the action as plaintiffs (at paras 184 – 195).

Justice O'Ferrall had a different view. While he concluded that the leases terminated back in 1995 when the lessees abandoned all operation in productive zones in the well, he was also of the view that the lessees did not become trespassers immediately. Indeed, in his view, they only become trespassers when served with a notice to vacate in September 2005, a month after the filing of the statement of claim:

> … in the absence of any steps being taken by the lessors to exclude the lessees, the lessees were not trespassers following cessation of production in 1995. The lessees had initially come on the lands as a matter of right. They had produced the natural gas as a matter of right. They then lost that right. But at that point, in the absence of any steps being taken by the owners of the hydrocarbons, the lessees did not become trespassers. No action was taken by the lessors. Their acceptance of rentals and royalties, while it did not revive the terminated leases, did indicate that the lessors consented to the *status quo*. And, for their part, given their prior mutually-beneficial and lengthy relationship, the lessees were justified in believing they could continue to conduct themselves on the assumption that the landowners took no objection to the resumption of production operations in

> March 2001. The legal fact that their leases were subject to termination in accordance with their terms is of no consequence if no steps are taken by lessors to eject their lessees.
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> [431] .... until the lessors made it clear to their lessees that they no longer consented to continued production, the leases may have been subject to termination, but the lessors were not entitled to damages for trespass or conversion. The lessors had to make it clear that they were relying on that termination.
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> [432] But once the lessors served notices to vacate, the fact that they continued to accept royalties from the wrongful conversion of their hydrocarbons is of no consequence. Acquiescence in continued production of the well and acceptance of royalties was not indicative of consent. At that point, the lessors were simply accepting proceeds of the sale of a portion of the production which belonged to them and which the lessees persisted in wrongly converting in the face of a notice to vacate. The hydrocarbons were owned by the lessors. By continuing to accept royalty payments, the lessors were simply receiving a part of the benefit to which they were entitled by virtue of their ownership.
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> [433] Once served with the Notice to Vacate in September 2005, the lessees were not innocent tortfeasors who acted under the mistaken belief that they were acting lawfully. The lessees had been warned by at least one very experienced petroleum landman that their leases had terminated. It wasn't until several years later that they were served with notices to vacate. But, having been served and armed with the advice they had received, the lessees took the position that they were acting lawfully, knowing full well that their position might not be sustained….

This seems more than a little strange and inconsistent with the conclusion that the leases had expired in 1995 (and see also Justice O'Ferrall's remarks at para 416 and quoted below under the heading "cause of action"). Conversion is a strict liability tort: it doesn't matter if the person converting is "innocent". And even if the lessees are not trespassers because they entered with permission (which proposition Justice Rowbotham rejects) it is hard to read any continuing licence that the former lessees might have with respect to surface operations as extending to production operations that dissipates the lessors' reversionary interests, or as in some way waiving the lessors' ownership interest in the severed substances.

The Legal Status of Production Operations on a Dead Lease, the Remedy, and the Assessment of Damages

All three members of the Court concluded that the leases terminated before production re-commenced in 2001 and that for at least some of this time the lessees were producing without the permission of the lessors. It was therefore necessary for the Court to consider the legal status of these producing operations on a dead lease and the remedies available to the lessors, including the basis for assessing damages for unlawful production.

Production on a dead lease for which there is no continuing leave and licence (as above, per Justice O'Ferrall) is unlawful but there is a lively debate about how to characterize that production within existing causes of action, including the relevant torts and the independent cause of action of unjust enrichment. I have canvassed some of these issues in an article referred to by Justice Rowbotham in her decision: Nigel Bankes, "Termination of an Oil and Gas Lease,

Covenants as to Title, and Assessment of Damages for Wrongful Severance of Natural Resources: A Comment on *Williston Wildcatters*" (2005) 68 Sask L Rev 23.

The Cause of Action

Within the domain of tort there are two causes of action to which lessors resort: trespass (to land) and conversion (of chattels). The Court found that the lessors could rely on both (at para 171). Thus at paras 166 – 168 the majority (per Justice Rowbotham, McDonald JA concurring) concluded that production on a dead lease constituted trespass to the lessors' reversionary interests: "When the right to go on the land and sever the minerals has terminated but severance nevertheless continues, the reversioner has been deprived of its fee interest, which constitutes the trespass of the reversion." Similarly, Justice Rowbotham finds there to be conversion - albeit citing (at para 169) a rather odd definition of conversion from Klar's, *Tort Law*, which emphasizes possession rather than interference with title or the rights of the owner as the gravamen of conversion. Given these findings, Justice Rowbotham found it unnecessary to discuss the availability of a cause of action in unjust enrichment.

Justice O'Ferrall gave independent reasons for concluding that there was both a trespass and a conversion (at para 416 and n 6):

> [416] the court is not simply compensating for trespass. It is also compensating for a wrongful conversion. In other words, the wrongdoers (the lessees) not only overheld, but they also damaged (depleted or wasted) the reversion while they overheld. An irreplaceable value was taken from the fee. This was not simply a wrongful occupation of land for which compensation for use and occupation (e.g., rent) might be appropriate. This was a wrongful failure to vacate accompanied by a wrongful conversion of personal property (when the hydrocarbons were severed from the realty and produced by the lessees) for which the value of the goods wrongfully converted may be an appropriate measure of damages.
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> [n 6] The debate over whether there can be a trespass to mines and minerals should be put to bed. Mines and minerals are interests in land .... To suggest that the registered owner of the mines and minerals underlying Blackacre lacks possession, and therefore cannot sue in trespass because he is not actually mining the mines and minerals, is to suggest that a farmer owning unused, vacant land hasn't sufficient possession to sue in trespass. Mines and minerals, like vacant land, can be trespassed upon in a variety of ways. Subject to the rule of capture, minerals can also be wrongfully converted when a party without authority reduces them to possession by severing them from the subterrain. Also, the principle that an overholding tenant cannot be sued in trespass loses its validity when the overholding tenant refuses to vacate when given proper notice to do so.

The Assessment of Damages

Prior to this decision, the general direction of the case law in Canada seemed to be to the effect that damages awards for unlawful production of resources after the expiration of the lease should be strictly compensatory (in the absence of bad faith or other unconscionable conduct on the part of the lessee) and that the best measure of such a compensatory award would be a royalty (perhaps not the royalty prescribed by the dead lease but another amount such as the royalty prevailing in the area at the relevant time) and a new bonus payment: see *Williston Wildcatters* and *Freyberg*. There are all sorts of difficulties with this approach which are referred to in both

of the leading judgements in this case: see Justice Rowbotham at paras 208 – 213 and Justice O'Ferrall at paras 421 - 424). The bottom line is that all three judges *generally* reject the royalty approach or the royalty-plus-bonus approach as an appropriate means of assessing damages in cases such as these. That said, Justice O'Ferrall in particular is at pains to emphasise (at paras 413, 421, 437 & 440) that he is articulating no general principle and that much will depend on the facts of each case. Indeed, Justice O'Ferrall suggests (at para 440) that the royalty-plus-bonus approach might be appropriate in some circumstances and that the Court should be concerned that a disgorgement approach may simply (at para 445) "[stir] up trouble in the oil patch by awarding the net benefits of production received by the lessees" a return to the lessors greater "than they could have dreamed of ever realizing from their ownership of the minerals".

It was implicit if not explicit in the former approach of *Williston Wildcatters* and *Freyberg* that the courts were rejecting a disgorgement (or unjust enrichment) approach in which the lessees would be required to disgorge their ill-gotten gains and make restoration to the lessors of the wrongfully produced and marketed substances. In this case, all three judges endorse disgorgement as the most appropriate means of assessing damages in cases such as these. In doing so, Justices O'Ferrall, McDonald and Rowbotham all rely heavily on the old decision of the Supreme Court of Canada (and the Saskatchewan Court of Appeal) in *Sohio Petroleum Co. et al v Weyburn Security Co Ltd,* 1970 CanLII 137 (SCC), [1971] SCR 81, 13 DLR (3d) 340, aff'g (1969), 1969 CanLII 625 (SK CA), 7 DLR (3d) 277 (SKCA). However, while all agree on the source of authority for this approach (and indeed all suggest that the result in this case is *required* by *Sohio*, see Justice Rowbotham at para 207, Justice McDonald at para 314 and Justice O'Ferrall at paras 412 - 413) they differ on the application of *Sohio* and on the important question of what costs, if any, the lessee should be able to claim as a deduction from the gross proceeds received from producing and marketing the product.

One of the difficulties with relying so heavily on *Sohio* is that the judgement is, to say the least, cryptic and the Supreme Court of Canada does not provide independent reasons for endorsing disgorgement as an appropriate means of assessing damages. Instead, the Court instead simply repeats the reasons offered by the Saskatchewan Court of Appeal. Those reasons in their entirety were as follows (as quoted by Justice Rowbotham at para 203 with her emphasis added):

> The [lessor] requested that the judgment of the Court of Appeal be varied in so far as it dealt with the date from which the [lessee] should be required to account to the [lessor] for production taken from the leased lands. The [lessor] contends that the date should be October 28, 1959, the date on which the lease terminated, subject to an allowance for expenses incurred by the [lessee]. This phase of the matter was dealt with in the following passage from the judgment of the Court of Appeal:
>
> > The [lessor] also sought an accounting of all petroleum, natural gas and related hydrocarbons removed from the land by the [lessee], or damages in lieu thereof. The court has jurisdiction to grant this relief on terms which will be just and equitable to all parties involved. The [lessee] proceeded under a mistake as to its rights, and did not knowingly take an unfair advantage of the [lessor's] lack of appreciation of its legal rights. The [lessees] were first aware that their position was challenged when the writ of summons was served upon them. At that time the revenue which they had received from the sale of the production exceeded the amount they had expended. Under the

> circumstances, it would appear just and equitable to order the [lessee] to account for all benefits from production received by them after the date of service of the writ of summons upon them.

In effect, Justice Rowbotham (for the majority on this point) concludes (at para 218) that "all benefits" is a net concept which must allow the defendant lessees to recover their operating expenses but no expenses attributable to drilling or recompletion – since these expenses can never be for the account of the royalty owner (at para 230). In reaching this conclusion Justice Rowbotham evidently seeks to move beyond the language of hard and mild rules for recovery (which dominates the older case law), for it is her view (and I wholeheartedly concur) that disgorgement in these cases (with allowance for expenses) is not a punitive remedy (and see also Justice O'Ferrall at para 417 and then at 437) and that if a lessee is deserving of sanction, that sanction should take the form of a punitive damages award (at paras 221 – 223). Justice O'Ferrall agreed with this outcome (see at para 447) although he gave rather different reasons for concluding that the lessees should be able to make deductions choosing to emphasize that the royalty provisions of the lease allow a lessee to make deductions against royalties with respect to any enhanced value (e.g. through transportation and processing and see *Acanthus Resources Ltd. v Cunningham*, 1998 ABQB 168) conferred by a lessee post severance (at para 415): "If the lessors were prepared to have those costs deducted before their 12 1/2% royalty shares were calculated, it seems appropriate to deduct those costs after they became entitled to 100% of the value of the produced substances."

Justice McDonald (dissenting on this point) took a more hawkish view of the behavior of the lessees in this case. In his view, the lessees were not acting in good faith. The lessees clearly had doubts as to the validity of their leases and yet still re-completed and re-commenced production. This "egregious behavior" (at para 317) fully justified imposition of the so-called harsh rule such that (at para 317) Justice McDonald would have directed "the respondents disgorge the full amount of the revenue obtained from the subject leases, without any deduction for operating or other costs, for the period commencing two years prior to the issuance of the statement of claim." Justice McDonald went on to say (at para 318) that this ruling was also consistent with the Supreme Court of Canada's decisions on punitive damages (*Vorvis v Insurance Corporation of British Columbia*, 1989 CanLII 93 (SCC), [1989] 1 SCR 1085, 58 DLR (4th) 193; *Whiten v Pilot Insurance Company*, 2002 SCC 18 (CanLII), [2002] 1 SCR 595) although he does not seem to have concluded that this justified a separate and additional punitive damages award. Perhaps he was of the view that the difference between gross receipts, and gross receipts minus what Justice Rowbotham considered to be reasonable operating costs, represented an appropriate award of punitive damages.

The Liability of the Gross Overriding Royalty Owner (Esprit)

In addition to suing the working interest owners in tort and unjust enrichment, the lessors also sued Esprit which held a gross overriding royalty (GORR). In that capacity, Esprit had received royalty payments from its working interest owner (Bonavista). Esprit's royalty interest dated from June 1, 2000. It appears (Justice Rowbotham at para 247) that Esprit is sued in trespass and conversion. The majority (Justices McDonald and O'Ferrall) concluded that the lessors did have an independent cause of action against Esprit. Justice Rowbotham (dissenting on this point) held that Esprit could not be liable in tort to the lessors.

In relation to this matter, I will first consider Justice Rowbotham's opinion and then turn to the majority.

Justice Rowbotham first concluded that there was no basis for interfering with Justice Romaine's conclusion at trial to the effect that Esprit was not a joint tortfeasor and therefore could not be held jointly and severally liable - principally on the basis of what is said to be the absence of the necessary degree of proximity (at para 252) (Justices O'Ferrall and McDonald concur on this point, see at para 468). That left, according to Justice Rowbotham, the question of whether or not the lessors might claim disgorgement against Esprit (at para 253). With respect, this is a rather odd way of putting the matter. Disgorgement (unlike unjust enrichment) is not a cause of action; it is one possible characterization of the measure of damages where a plaintiff has established liability (whether in tort, contract or unjust enrichment). We first need to know whether the lessors have a cause of action against Esprit.

On the face of it, there can be no liability in contract because there is no privity between Esprit and the lessors. It is also exceptionally hard to see how the facts might meet any of the possibly relevant causes of action in tort. There can be no trespass to land committed by Esprit since the holder of a GORR has no possessory rights. Neither can there be trespass to chattels since Esprit never took possession of somebody else's chattels. But it is also hard to see how there can be a conversion, because even if we concede that the severed gas is the personal property of the lessors, Esprit has not interfered with that personal property. It is true that Esprit had the right to take its royalty in kind but it did not do so. Instead, it received payments based upon its contractual entitlements with its counterparty (Bonavista). It did not act in a manner that was inconsistent with the rights of the true owner of the natural gas and therefore did not commit the tort of conversion. It may be that Esprit's counterparty can recover the royalty that it has paid Esprit on the basis of mistake of law (i.e. no liability to pay because the lease is invalid and therefore the GORR must have died with the lease) and unjust enrichment, but it is hard to characterize Esprit as a tortfeasor against the lessors.

The lessors seem to have tried to get around this problem by arguing the law of agency. The premise here must be that the relevant working interest owner committed the alleged wrong (tort or unjust enrichment) as the agent for Esprit as principal and thus that Esprit must assume that liability. The alleged wrong must relate to the lessors' gas. At first blush this is rather far-fetched unless the GORR holder takes in kind. If it does so, and if the working interest owner out of which the GORR is carved has no title to the natural gas, then it is conceivable that the GORR holder will commit the tort of conversion, since, by taking delivery and\or selling that gas the GORR holder is purporting to exercise the rights of the owner. If the GORR holder does not take in kind, the only party that commits the tort is the working interest owner (and conceivably the parties to whom it sells). The subsequent payment on account to the royalty owner is not tainted by the wrongful sale of the gas by the working interest owner. The lessors could only follow (trace) the proceeds of sale of the gas if the GORR holder were a trustee for the lessors – which of course is not the case.

But sometimes GORR owners attempt to do weird and wonderful things in order to maximize the chances of characterizing the royalty as an interest in land, even if they do not take in kind. One such example of this drafting wizardry is for the contract to designate the relationship between the working interest owner and the royalty owner as an agency relationship. Such was the case here since the royalty agreement incorporated (at para 245) the terms of CAPL's 1997 Overriding Royalty Procedure which provides that where the payee (Esprit) elects not to take in kind the payor (Bonavista) "will act as Esprit's agent ... for the handling and disposition" of its

royalty share of the gas and Bonavista will "be as a trustee" for Esprit." While it seems clear law that a principal must bear responsibility for the torts committed by its agent in the course of the agency relationship (at para 254) Justice Romaine at trial was not prepared to concede that the mere assertion of an agency relationship (as well as a trust relationship) in the CAPL form was enough to establish that agency. This seems problematic (after all, that's what the contract said and the contracting parties should not be able to pick and choose different parts of the contractual language depending on the issue or argument they are seeking to respond to) but Justice Rowbotham declined to interfere. She suggested that the existence of an agency relationship is partly a question of fact and therefore a matter on which it was appropriate to defer to the trial judge. While that was enough to decide the case for Justice Rowbotham her conclusion takes the form of an assertion rather than a fully reasoned conclusion. It does suggest to me that GORR owners might want to think carefully about the risks of proclaiming a principal\agent relationship with their working interest owners. That said, I think that the risk here must be limited to the GORR owner's royalty share of the gas that the working interest owner sells. I don't see how it could extend to the entire volume of sales gas on the basis of an agency relationship. This is because that agency relationship must be confined to the GORR owner's share of the gas – albeit a commingled share.

Justice O'Ferrall (McDonald JA concurring) for the majority seems to have concluded that Esprit's behavior was wrongful as against the lessors without needing to resort to the law of agency. The crucial passage is at para 467:

> … Esprit received the value of a portion of the production coming out of the 7-25 Well. Esprit was paid that value rather than taking its gross overriding royalty share of production in kind. But Esprit was not entitled to that value because the lessees of those lands were not entitled to the natural gas produced. The leases had terminated and once the underlying lease terminates, the overriding royalty interest expires. … But since Esprit continued to receive an overriding royalty interest share of production from the 7-25 Well after the leases had terminated, it was obligated to account for that share of production which it received in the form of gross overriding payments. Esprit was not entitled to that share. It wrongly received a portion of the value of the natural gas which belonged to the lessors (emphasis added).

The problem with this passage is that Justice O'Ferrall never tells us what might be the basis of the duty to account and on what basis Esprit's behavior was wrongful as against the lessors. What is the cause of action?

Nevertheless, having made these findings Justice O'Ferrall then appears to equivocate as evidenced by the following paragraph which seems to suggest that the issue is perhaps better dealt with as between Esprit and its counterparty Bonavista (at 468):

> The fact that Esprit, as an overriding royalty interest owner, was not a working interest owner meant only that Esprit could not be held jointly and severally liable for the value of all the natural gas wrongfully converted. But that does not absolve it from accounting for the royalty share of production it continued to collect …. In the Agreed Statement of Revenues, Expenses and Royalties, Esprit's gross overriding royalties were deducted from the lessees' (Bonavista's) income from production. So either the lessees are not entitled to that deduction or Esprit is independently liable to the lessors for the royalties it received. That is a matter to be left to Bonavista and Esprit. … We leave it to the parties to implement our direction, with any disputes to be settled by the trial judge or another judge of the Court of Queen's Bench (emphasis added).

I agree that the *lessees* cannot reduce their liability to the lessors by referring to and relying on GORR payments they had no obligation to make, but it does not follow from this that *Esprit* had any liability (whether based on tort or unjust enrichment) to the *lessors*. In sum, the issue is an issue to be resolved between Esprit and Bonavista. The lessors can recover in full from their lessees (jointly and severally); and the lessees (Bonavista) may be able to recover a portion of its damages assessment from the holder of the GORR who had no right to be paid.

Conclusions

This is already a long post and so I will conclude where I began: interesting case, lots of important issues, lots to argue about in the future – and a very difficult case to untangle. I hope that I have captured where the majority lies on the different issues but I certainly invite comments if readers have different assessments of the judicial alignments than those presented in this post.