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Making Sense of Nonsense? Or Perhaps Not

By: Nigel Bankes and Heather Lilles

Case Commented On: *Eon Energy Ltd v Ferrybank Resources Ltd*, 2016 ABQB 585 (CanLII)

What happens when two oil and gas companies enter into a joint operating agreement (JOA) to which is attached the 1981 CAPL Operating Procedure and the PASWC Accounting Procedure and then proceed to operate the properties according to a completely different set of arrangements? As one might expect, things are fine for so long as each perceives some benefit from these *de facto* arrangements. But when relations deteriorate it's a mess; and then both counsel, and ultimately the Court, have to try and make sense of what has happened. And in this case that evidently proved difficult for all concerned and likely, very, very expensive. The hearing of this case took 16 days and then Justice Kim Nixon took two years to render this judgement. There were also interlocutory injunctive proceedings (unreported) and there will be a series of accounting issues to be addressed as a result of this judgement. The result is extremely unedifying. The judgement is long (53 pages), meandering, fact laden, and convoluted. Perhaps the best that can be said for it is that it might serve as a salutary warning to be used by lawyers acting for junior oil and gas companies: "this is what happens when you make things up as you go along and act as if the written agreement is a mere inconvenience." The case is also another illustration of the hard reality that co-ownership is a messy business and fundamentally an institution for those who can get along together. Sometimes the costs of maintaining and fighting about the relationship are not worth the benefits to be obtained.

In one of the more enigmatic paragraphs of her decision Justice Nixon suggests that the parties are asking her to re-write their agreement (at para 260 and again at para 397). But the question all along is which agreement? The written agreement? Or the agreement evidenced by the conduct of the parties?

In what follows we will do our best to distill the essential facts and legal reasoning from Justice Nixon's judgement.

The written agreements between the parties

Ferrybank Resources Ltd. (Ferrybank) and Eon Energy Ltd. (Eon) entered into a Confirmation of Interests and Joint Operating Agreement (the JOA) on February 1, 2001 in respect of six wells (three of these wells were later sold leaving the 2-01, 4-07 and 6-07 wells in dispute). The agreement confirmed that Ferrybank held a 10% working interest and Eon held a 90% working interest in all petroleum substances. There was a 1981 CAPL Operating Procedure (the 1981 CAPL) and a 1983 Petroleum Accountants Society of Canada (PASC) Accounting Procedure appended to the JOA. The JOA appointed Ferrybank as the "Initial Operator", well-licensee, and the party responsible for entering into marketing agreements with third parties. (at paras 13-15, 247) It would ordinarily follow from these arrangements that Ferrybank and Eon would each be responsible for their proportionate share (10:90) of the costs, expenses and liabilities associated with the properties and also be entitled to the same proportionate share of production and revenues.

The JOA and annexes contained two express provisions with respect to operator fees. The same clause of the JOA (cl. 8(b)) by which Ferrybank appointed Eon "as its sole agent for the purposes of managing the operations on the Joint Lands" also provided that Ferrybank would not be charged its share of operating overhead but would instead receive from Eon '$200 per well per month to perform its [functions as the] registered and designated operator of the Assets." (at para 173) We will refer to this as the administrative fee. The second provision purported to be an election for overhead expenses in the PASC accounting procedure which provides for a $225 per month per producing well operator fee (at paras 176-179). We will refer to this as the PASC well fee.

The same parties acquired a joint interest in four additional wells in the same percentages in October 2001. There was no executed written agreement with respect to these additional wells (at para 6) although the terms of the agreement were set out in a letter from Ferrybank to Eon (at paras 83-84).

The *de facto* arrangements between the parties

The *de facto* arrangements between the parties were significantly at variance from the terms of their written agreements. The differences included the following: (1) Eon was the *de facto* operator of all of the wells; (2) with the exception of the 6-25 well and solution gas production from the 4-07 and 6-07 wells for the first ten years, Ferrybank neither contributed its 10% share of costs and expenses nor received the reciprocal revenues, (the solution gas expenses and revenues for the listed wells were dealt with in accordance with the JOA (at para 18) although with very tardy accounting processes); (3) as of 2004 the parties agreed to share the 6-25 well 50:50 on the condition that Ferrybank repair the pump on the well at its sole risk and expense. The 6-25 well was one of the second groups of wells acquired by the parties. (4) As for the operator fees, the record demonstrated that Ferrybank never billed Eon for the administrative fees provided for under cl. 8(b) of the JOA (at para 194) for ten years. (5) Although the CAPL operating procedure requires the operator to keep the joint accounts neither party (at para 255) kept a joint account for any of the wells.

The reasons for the variances

The underlying reason for the dissonance between the written agreements and the actual conduct of the parties or their *de facto* arrangements seems to have been to game the Licence Liability Rating Program (LLR program) of the Alberta Energy Regulator (AER). Under that scheme an oil and gas licensee in the province must maintain a positive ratio of deemed assets to deemed liabilities for the wells for which it is the licensee. In the event of a negative ratio a licensee is required to make good the shortfall with a deposit. Non-productive wells have a negative effect on the ratio. The calculation does not take account of the beneficial ownership of the wells. A licensee is deemed to have a 100% interest. The practical effect of having Ferrybank as licensee was that Ferrybank's other producing wells would generate a positive ratio (and fitted in with Eon's principal's plans to move his operations to British Columbia). Section 91(2) of the *Oil and Gas Conservation Act*, RSA 2000, c O-6 (OGCA) prescribes that a licensee or approval holder that is resident outside of Alberta must appoint an agent within Alberta to carry out the licensee's or approval holder's duties and other responsibilities under the *OGCA* and perhaps the parties were trying to avoid that complication. However, this also meant that it was Ferrybank that was principally responsible to the regulator. Over time, Ferrybank also became concerned that it might need to make a security deposit with the AER as its own LLR declined; and indeed it was required to make such a deposit (at para 241) when the 6-25 well stopped producing in 2010 for the second time and following changes to the LLR program.

The disputes between the parties

Justice Nixon canvasses the many disputes that arose between the parties as a result of the above arrangements and the souring of their relationship. We will refer to five main issues: (1) issues with respect to purported variations in the size of the working interests, (2) issues with respect to operator fees, (3) issues related to foregone production from the 6-25 well, (4) change of operator issues, and (5) the right to take in kind.

(1) The working interest ownership issues

The court held that the parties held 10% (Ferrybank) and 90% (Eon) working interests in all of the properties still held by them. This was what the executed written agreement provided for in the case of the original six wells. This agreement included an entire agreement clause which also precluded any amendment except by agreement in writing signed by both parties (at para. 71). However the parties could, by oral agreement, apply the same rules to the four wells subsequently acquired. We agree with this finding (at para 86) but would have added that such an oral agreement, insofar as it deals with interests in lands would also have had to comply with the *Statute of Frauds* which requires that the agreement be evidenced in writing signed by at least the party against whom it is to be enforced (or otherwise evidenced by sufficient acts of part performance.) That said, we note that a party must expressly plead the *Statute of Frauds* and perhaps it was not pled in this case. There was at least some evidence (at paras 83 to 85 and indeed scattered throughout the judgement) of the sufficiency of the necessary evidence in writing but there is no assessment of that evidence in the judgement nor any assessment of issues of part performance (although there are analogous estoppel considerations). See the many discussions on ABlawg of the status of the rules relating to part performance in Alberta by Professor Jonnette Watson Hamilton, most recently here.

For Justice Nixon it also followed that the arrangements between the parties as to the subsequently acquired four wells, including the 6-25 well, could also be amended orally (at para 97). This is less obvious to us (after all, the arrangements now include a set of provisions that require that any amendments be in writing); and again we would argue that, at the very least, any such amendments would also have to comply with the *Statute of Frauds* as above.

The implications of the subsequent conduct of the parties

If the 90:10 arrangements with respect to the originally acquired wells could not be amended without the written agreement of the parties what should be the consequences of that? It would seem to follow that, subject to the *Limitations Act*, RSA 2000, c. L-12, Eon should have to account to Ferrybank for 10% of revenues but should be able to recover 10% of the costs. In practice, given the limitations period, this would only apply to the period commencing two years from when the action was begun.

This seems to us to be a rather simple conclusion and not obviously unjust to either party - although there is some unfairness to Eon since it bore the sole risk of continued operations (but there does not seem to be much evidence that the risks were high).

However, the parties (and Justice Nixon) preferred a much more complicated solution drawing on estoppel. The conclusion seems to have been that since the parties were agreed that oral amendments could be effective, each must be estopped from resiling from that oral amendment (at para 95). On the evidence (which is painfully discussed from paras 100 – 150), the oral agreement was not an agreement whereby Ferrybank gave up its 10% interest but was instead an agreement whereby the parties agreed to suspend the usual sharing obligations as to costs and revenues associated with a proportionate working interest. Thus, Eon could keep 100% of production while paying 100% of the costs (*quaere* what would the parties have said about Ferrybank's liability if something had gone seriously awry). As for the form of estoppel, the parties apparently canvassed proprietary estoppel, estoppel by convention, and promissory estoppel (at para 153). Justice Nixon plumped for estoppel by convention without indicating why the other forms of estoppel were not available. The estoppel served to suspend the sharing obligations of the JOA until Ferrybank served its counterclaim on Eon. Justice Nixon set out the elements of estoppel by convention (at para 157) relying on the Supreme Court of Canada decision in *Ryan v Moore*, 2005 SCC 38 (CanLII) (at para 59):

> (1) The parties' dealings must have been based on a shared assumption of fact or law: estoppel requires manifest representation by statement or conduct creating a mutual assumption. Nevertheless, estoppel can arise out of ***silence*** (impliedly) [emphasis in original]
>
> (2) A party must have conducted itself, i.e. acted, in reliance on such shared assumption, its actions resulting in a change of its legal position.
>
> (3) It must also be unjust or unfair to allow one of the parties to resile or depart from the common assumption. The party seeking to establish estoppel therefore has to prove that detriment will be suffered if the other party is allowed to resile from the assumption since there has been a change from the presumed position.

Perhaps the most difficult of these criteria to fill on the facts was the third criterion and here Justice Nixon seems somewhat equivocal, concluding as follows (at para 160):

> Having left Eon to pay 100% of these costs and expenses and take 100% of the risk with respect to the operations, it would be unfair to permit Ferrybank to resile from the parties' shared assumption with respect to oil revenues. Ferrybank cannot claim oil revenues retrospectively. However, there is no evidence Eon took any specific risks with respect to the operation of these wells that would make it unjust for Ferrybank to receive oil revenues net of costs and expenses from the time it served its Counterclaim.

On the other hand, Justice Nixon concluded that waiver would not be available since waiver applied to a situation where one party intentionally and unequivocally relinquishes a right which it holds under the contract (at para 162).

The principal practical difference between simply applying the contract (subject to the limitations rules) and applying estoppel rules is that under the estoppel approach the written agreement re-establishes itself as of the date of service of the counter claim; the contract approach would restore the pre-eminence of the written arrangement two years earlier.

The subsequently acquired wells including the 6-25 well

The analysis was different in relation to the subsequently acquired wells (including the 6-25 well) since, as noted above, Justice Nixon found that there was no limit on the ability of the parties to vary the original oral agreement by further oral amendments and that the evidence confirmed that they had done so in relation to the 6-25 well. Recall as well that it seems as if Ferrybank is both *de jure* and *de facto* operator of this well on the basis of its commitment to replace the pump for that well.

Referring (at para 208) to *Powermax Energy Inc v Argonauts Group Ltd*, 2003 ABQB 71 (CanLII), at para 117 citing *Bank of Nova Scotia v Société Générale Canada)*, 1988 CanLII 166 (AB CA), 87 AR 133; *Adeco Exploration Company Ltd v Hunt Oil Company of Canada Inc*, 2008 ABCA 214 (CanLII) at para 68, citing *Erehwon Exploration Ltd v Northstar Energy Corp*, 1993 CanLII 7238 (AB QB) Justice Nixon recalled that each party had a duty to account to the other as a fiduciary for any production revenues it received in relation to the jointly owned wells. Ferrybank "is not entitled to withhold revenues from Eon in anticipation of a possible LLR deposit" or "on the basis that the LLR is a 'regulatory burden' on each well" (at para 212).

The court ordered an audit with respect to the "records of the other relevant to their joint venture" (at para 215) to be paid for by both parties in accordance with their respective working interest; the auditor to "have a charge on the production of the defaulting party to recover any unpaid share of costs." (at para 219)

(2) Operator fees

As noted above, the written agreements (at least with respect to the first group of wells) contained two sets of provisions with respect to operator fees. These gave rise to at least two interpretation problems as a matter of the text. The first question (not necessarily the order of issues as discussed by Justice Nixon at paras 172 – 183) was whether the arrangement actually contemplated both fees; the second was the question of who was the operator for the purposes of the PASC well fee. The commercial context for both questions undoubtedly included the rather unusual arrangement in which one party was the operator of record for official purposes and another party was the *de facto* operator for the physical operation purposes (but not all commercial purposes). In the end, Justice Nixon seems to have concluded that the agreements between the parties did contemplate both the administrative fee and the PASC well fee but with a different beneficiary in each case. The beneficiary of the administrative fee was Ferrybank; the beneficiary of the PASC well fee was Eon. While the former was not subject to prorating, the PASC well fee was, but in this case cl.8(b) of the JOA expressly relieved Ferrybank of its liability for its 10% share. We agree with this analysis of this rather unusual arrangement.

As a result of this interpretation Ferrybank should be able to recover the administrative fee payable by Eon (subject only to any time bar imposed by the *Limitations Act*) - unless the parties had varied the terms of the contract by oral agreement or by their conduct in a manner that was binding notwithstanding the entire agreement\no amendment except in writing clause of the JOA. Justice Nixon concluded that the evidence did not establish an oral amendment – indeed (at para 192) "There was a dirth (*sic*) of evidence about fees." However, (at para 198) "Ferrybank's long failure to include fees in the accounts it submitted to Eon constitute a waiver". Ferrybank was entitled to withdraw that waiver prospectively and upon reasonable notice. Ferrybank did this when it started billing Eon in December 2010 for its fees under cl.8(b). Justice Nixon does not explain (or refer to) how waiver operates in light of cl. 2001 of the 1981 CAPL which provides as follows:

> No waiver by any party of any breach of any of the covenants, provisos, conditions, restrictions or stipulations herein contained shall take effect or be binding upon that party unless the same be expressed in writing under the authority of that party and any waiver so given shall extend only to the particular breach so waived and shall not limit or affect any rights with respect to any other or future breach.

There was no estoppel that would preclude recovery:

> Estoppel by convention does not apply to fees as it did to oil revenues because there was no joint understanding between the parties with respect to fees. As there was no detrimental reliance by Eon on Ferrybank's failure to claim or to bill for fees, neither of the other two other forms of estoppel raised by Eon, propriety estoppel and promissory estoppel, apply either.

(at para 204)

(3) Foregone production from the 6-25 well

As noted above, the 6-25 well ceased production for the second time in 2010 at which time the parties disagreed as to what action to take. There were competing independent operations notices and court injunctions preventing either party working on the well until Ferrybank secured a court order (at para 242) permitting it to repair the pump on the 6-25 well at its sole expense. That operation was successful and production resumed in September 2013 after a three year hiatus. Ferrybank claimed damages from Eon based on the foregone production and perhaps also for losses it suffered as a result of having to make an LLR deposit with the AER due to the loss of the 6-25 well as a producing well in Ferrybank's LLR ratio calculations.

The Court rejected this claim (at para 244) on the basis that the above facts did not demonstrate a cause of action. We agree. There is no duty upon co-owners to agree as to how they shall use or operate the property just as, without more, co-owners do no owe each other a fiduciary duty: *Kennedy v De Trafford*, [1897] AC 180 (HL E).

(4) Change of operator issues

Both parties seem to have had an interest in changing the status of the other under their working arrangements but different rules apply to the removal of the *de jure* operator and the *de facto* operator. The operating procedure provides the rules for removing or changing Ferrybank's status as the *de jure* operator or operator of record. Eon's status as the *de facto* operator is governed by Ferrybank's delegation of that authority under cl 8(b) of the JOA.

Proposed removal of Eon as the de facto operator

In seeking to terminate Eon's position as the *de facto* operator Ferrybank seems to have argued that the arrangement should be terminated because Eon was in breach of its fiduciary obligations as agent of Ferrybank or otherwise in breach of its duties of good faith in relation to the contract, or in breach of various court orders. These arguments all failed. Justice Nixon goes so far as to say (at para 280) that Eon was not an agent and therefore owes no fiduciary duty to Ferrybank; and later she reaches the flat conclusion that "Ferrybank is not entitled to remove Eon" from its *de facto* role. (at para 317) But we wonder why Ferrybank needed to show breach of any duty to terminate the "agency" or Eon's *de facto* role. Cl.8(b) is nothing more than a declaration of an initial appointment. Unless there is something else in Cl.8 of the JOA that requires this appointment to continue it is not clear to us why it was not open to Ferrybank simply to terminate that appointment on reasonable notice. In other words there was perhaps a preliminary interpretive issue which seems to have been glossed over.

Proposed removal of Ferrybank as de jure operator

Justice Nixon considered Eon's claim to have Ferrybank removed as operator under three headings: (1) breach of fiduciary duty, (2) clause 202 of the operating procedure, and (3) the challenge provisions.

The CAPL operating procedure does not list "breach of fiduciary duty" as a ground for replacing an operator but that was Eon's argument and Justice Nixon examined it on that basis. Her conclusion was that Ferrybank was manifestly in breach its fiduciary obligations by failing to account for revenues received in relation to the 4-07, 6-07 and 6-25 wells (at paras 290 – 296) but that that did not entitle Eon to remove Ferrybank as operator because "Eon is not eligible to be the named Operator" (at para 298) and had no right to nominate a third party to so act. However, Ferrybank's chronic failures did "disentitle" it (at paras 392, 308, 330 & 384) from performing any operator functions in relation to these wells. Justice Nixon does not disclose why Ferrybank's breaches result in this "disentitlement".

The CAPL Operating Procedure (cl.202) does provide for removal of an operator on account of insolvency. Ferrybank was insolvent and therefore should be removed but it was not necessary to so order in this case because (at para 321) Eon was already the *de facto* operator. All that it was necessary to do in this case was to remove Ferrybank from its *de facto* operator roles in relation to the 4-07, 6-07 and 6-25 wells. The Court went on to confirm (at para 239) that it would be Eon's responsibility as the *de facto* operator to prepare and maintain the joint accounts. It's hard to know what to make of this solution. It offers a practical resolution to the inter-party problems posed by insolvency by making sure that Ferrybank never gets its hands on the cash flow; but on the other hand, perpetuating the parties' end run around the LLR program and leaving an insolvent party as the operator and licensee of record with the AER hardly seems to be a good outcome from a public policy perspective.

The arguments in relation to the challenge provisions are even more bizarre. The challenge concept is simple. A joint operator (Eon in this case) asserts (by a concrete proposal) that it can do the job more cheaply than the current operator (Ferrybank). Unless the operator agrees to operate on those terms it is deemed to have resigned. Eon claimed to have triggered these provisions. There were just a couple of problems with this assertion. First, Eon's fees look to be higher (at para 340) (and surely a proposed deduction in the penalty fee for independent operations does not count as better terms because it has nothing to do with the function of operator). And second because "Eon doesn't seek to become named Operator itself as it is ineligible to be such."[!!] (at para 334)

Justice Nixon was clearly of the view that the challenge notice was ineffective because it did not propose more favourable terms but she still went on to consider Ferrybank's argument that the notice was also ineffective on other grounds - namely because Eon was not "ready, able and willing to conduct operations" (at para 343) as required by Clause 203. One might have thought that the analysis here would turn on whether Eon's extraprovincial status would be an impediment but instead it turns out to be a post-mortem of Eon's actual performance as operator over the previous years. Yes, dear reader, that is correct. Ferrybank's argument is that Eon can't succeed with its challenge notice to be the *de jure* operator because Eon has done such a poor job of serving as the *de facto* operator. Thus, while the Court examines these issues under the heading of Eon's challenge of Ferrybank, in this surreal and twilight world of *de jure* and *de facto* operators Justice Nixon's assessment of why *Ferrybank's* attack on the substance of *Eon's* challenge notice (which is to remove *Ferrybank* as operator) must fail concludes as follows:

> In summary, Ferrybank's complaints about Eon's actions do not support the conclusion that Eon failed to conduct well operations properly. They do not support removal of Eon from well operations.
> (at para 377)

The complaints that Justice Nixon assessed included allegations of an improper workover of the 4-07 well, safety issues with the 2-01 well, and instructing third party contractors to deal with Eon not Ferrybank. A good number of these issues became arguments about the relative roles of *de jure* and *de facto* operators and the relationship between the written agreement and the agreement as varied by conduct. Thus, Ferrybank's argument with respect to the 4-07 workover was that Eon should have provided it with an AFE or an independent operations notice. Justice Nixon concluded that neither was required. An AFE was not required if the operation was under the $25,000 because Eon was conducting the operation as the (*de facto*) operator; if it was over $25,000 there was still no need for an AFE "because Ferrybank was not contributing anything towards expenses." (at para 350) And round and round we go. Equally, Eon could give directions to the third party contractors and have them deal with Eon as the *de facto* operator rather than Ferrybank as the *de jure* operator because "Eon, not Ferrybank, is the party authorized to manage, and to carry out operations on, the wells." (at para 376)

(5) The right to take in kind

Clause 601 of CAPL 1981 authorizes each party to take in kind. However, the JOA provided that in the event of a conflict between the JOA and the Operating Procedure the JOA would prevail. Eon's joint venture accountant took the view that there was a conflict between the two agreements (we don't have the text but apparently the JOA requires Ferrybank to issue directions to oil and gas marketers (at para 383)). It seems surprising that either JV accountant was permitted to opine on the issue of a potential conflict between the two agreements but Justice Nixon agreed with Eon's expert's assessment. We are not in a position to assess that conclusion without examining the text of the JOA but the right of a joint operator to market its own share of production is one of the fundamental rights of a co-owner which the CAPL forms address in some detail. One would expect clear language in the JOA to set aside this right over the entire term of operations on the joint lands (just as one might expect clear language to justify the conclusion that the delegation of *de facto* operator responsibilities is irrevocable for the duration of the contract).

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